PROCEEDINGS

OF THE TWENTY-FOURTH ANNUAL

Institute on Accounting

Held at

THE OHIO UNION
THE OHIO STATE UNIVERSITY CAMPUS

MAY 17 AND 18, 1962

Sponsored by

THE DEPARTMENT OF ACCOUNTING
COLLEGE OF COMMERCE AND ADMINISTRATION
THE OHIO STATE UNIVERSITY

Edited by

THE BUREAU OF BUSINESS RESEARCH
COLLEGE OF COMMERCE AND ADMINISTRATION

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POSTULATES: THEIR PLACE IN ACCOUNTING RESEARCH

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INTRODUCTION

I am pleased to have the opportunity to make my first appearance on the program of the Ohio State Institute on Accounting. Down through the years this Institute has achieved distinction through its inauguration and perpetuation of the Accounting Hall of Fame, and through its tradition of presenting outstanding speakers on challenging problems facing the accounting profession. The topic for discussion at this session—Accounting Postulates—and the two speakers who are to deal with it in depth following my introductory remarks, are certainly in keeping with this tradition.

In my talk at the annual meeting of the A.I.C.P.A. in Chicago last fall I stated that I regarded the further development, refinement, and exposition of accounting principles as the most important undertaking of the profession at this time. As you know, the Institute is currently engaged in an extensive research program devoted to this objective and the research study on accounting postulates is the first publication under this program.

At Chicago and at several subsequent meetings I have referred to the need for three principal forms of support of this program—understanding, participation, and financial support. My visit with you today gives me an opportunity to elaborate somewhat on my views on the need for understanding and participation by the profession as a whole; you may be relieved to be assured that I do not intend to make an appeal for financial support. Also, I do not intend to discuss the substance of the proposed postulates since they will be covered ably by the principal speakers.

UNDERSTANDING

I believe that a widespread understanding is desirable as to the need for the program of basic research, the plan of operation of the program, the function of postulates in the plan, and the importance and difficulty of developing satisfactory postulates and related principles.

Need for Research

The need for basic research was recognized by Al Jennings in his far-sighted proposal for a research program, by the special committee that recommended the organizational structure for carrying it out, and by the A.I.C.P.A. in implementing it. Fundamentally, the need for research arises from the fact that the profession has so many unsolved problems of major importance. However, I think it is important to understand that we have no occasion to feel apologetic about the existence of these problems. We should recognize that our present perplexing problems are not any indication of dilatory action in the past but, on the contrary, arise largely from changing conditions, the increasing complexity of business operations, and the expanding scope of our services to business and to the economy as a whole. Our candid acknowledgement of these problems and our constructive approach to resolving them is a healthy condition—a mark of the maturity and vigor of our professional organization. In fact, I know of no other profession that has undertaken such a comprehensive program of self-appraisal and improvement and I feel that we have every reason to be proud of this progressive endeavor.

Plan of Operation

Although the general plan of operation was given publicity in the early stages of the program, I believe it is worth while to review certain aspects of it as a background for our discussion today of the first research study. The plan provided for participation in the program by three separate groups: The Accounting Principles Board, the Research Division, and Project Advisory Committees. The Accounting Principles Board has the over-all responsibility for the program and it is the only agency having the authority to make or approve public pronouncements on accounting principles on behalf of the A.I.C.P.A. The Research Division has responsibility for conducting research assigned to it by the Accounting Principles Board and it has the authority to publish its findings and conclusions in the form of research studies. A Project Advisory Committee is established to advise and consult with the Research Division with respect to each project that is undertaken by the Division. As indicated by the name of these committees, their function is solely advisory; they do not have the responsibility of approving the research studies, although individual members do have the right to have any dissenting views included in the related publication.

Therefore, in considering the study of basic postulates, it should be clearly understood that it was issued under the authority of the director of the Research Division; it has not been approved by the Accounting Principles Board or the Project Advisory Committee; it is intended to be informative, but not conclusive; and it was issued for the purpose of stimulating constructive criticism for consideration by the Research Division and the Accounting Principles Board.

The Function of Postulates

The term "postulates" is one that, I suspect, is not used very often by most accountants in their everyday conversation. If some of you have not been quite clear concerning its precise meaning I am glad to join company with you. Furthermore, in the course of preparing for my remarks to you today, I was somewhat relieved to find that we apparently have much company outside our own profession, because it is evident that this word frequently is used in a variety of ways. Presumably in recognition of this condition, the American Institute's special committee that recommended the organization and approach for the research program specified the sense in which it used the term by defining postulates as "the basic assumptions on which principles rest." It indicated further that these assumptions necessarily are derived from the economic and political environment of the business community but that the profession should make clear its understanding and interpretation of them in order to provide a meaningful foundation for the formulation of principles and the development of rules or other guides for the application of principles in specific situations.

Criteria for Postulates

Since postulates are so clearly intended to serve as the foundation for the entire structure to be developed it seems worth while to consider some of the criteria by which any set of postulates may be judged before proceeding with the discussion of the specific postulates proposed for accounting. The following quotation from Susanne K. Langer's *Introduction to Symbolic Logic*, may be useful for this purpose:

> All we ask of a postulate is, (1) that it shall belong to the system. . . (2) that it shall imply further propositions of the system; (3) that it shall not contradict any other accepted postulate, or any proposition implied by such another postulate; and (4) it shall not itself be implied by other accepted postulates, jointly or singly taken.

Incidentally, I understand that our Research Director accepts these criteria as a satisfactory basis for judging the proposed postulates of accounting. With this in mind, I should like to present some of Mrs. Langer's views concerning such criteria and some of my own thoughts on their relations to the proposed postulates.

The author refers to the first requirement—that is, that a postulate should belong to the system—as *coherence*. For our purposes, this means that accounting postulates should be expressed in the language of accounting rather than in the language of some other discipline such as philosophy, mathematics, or natural science.

The second requirement—that a postulate should imply further propositions—is referred to as *contributiveness*. In this sense the word "postulate" is used to mean a "premise for deduction" and this seems to be the usage contemplated in our research program. The accounting postulates are to serve as a basis for the deduction of accounting principles. The author indicates that a proposed postulate may state a perfectly valid proposition and yet fail to be useful because it contributes nothing to the deduction of further propositions. I believe this is one of the crucial tests to be applied to the proposed postulate of accounting or to any alternative proposals.

The requirement that one postulate must not contradict another is designated by the author as *consistency*. To distinguish this requirement from our usual accounting concept of consistency, I will substitute *compatibility*. Logically, of course, two assumptions or premises that contradict each other cannot both be true. Therefore, the element of compatibility is an absolute essential to any set of postulates, whether they concern accounting or any other discipline.

The criterion that one postulate shall not be implied by another is referred to as *independence*. If a proposed postulate can be derived from another it is a demonstrable fact or a theorem, and consequently it is not a necessary assumption or postulate. This feature, however, is not as essential as the three mentioned previously, because conclusions derived from theorems are just as valid as those derived from postulates. In the context of our research in accounting, this means that our conclusions on specific problems do not depend on a precise distinction between postulates and principles. While we should, of course, strive to achieve a logical distinction in this respect, it is reassuring to realize that the end results of our research program do not depend on such distinction.

I think it is important that we keep in mind throughout the research program the primary objective for which it was established, namely, to provide a better basis for resolving problems in specific areas of accounting. The proposed basic postulates and related broad principles should be evaluated in terms of their contribution to this ultimate objective and they can best be considered together for this purpose.

Accounting Principles

Since the research study on broad principles has just recently been published many of you may not have had an opportunity to consider it carefully. If not, I urge you to do so at your earliest convenience. In the meantime, it may be helpful for the purpose of our discussion today to mention briefly some of the general areas covered in this study. It comprehends the nature and function of financial statements, the concepts of realization of profit, and definitions of basic terms such as assets, liabilities, owners' equity, retained earnings, revenue, cost, expenses, and profit. Although these terms are, of course, in current usage it is not too difficult to cite cases in which questions of interpretation can arise. This study also deals with such problems as the choice between economic substance and legal form in interpreting transactions, the time for recording assets and liabilities in the accounts, and the basis for determining the amounts at which they should be carried.

When we have stated the basic assumptions implicit in our economic environment and in the purposes for which financial statements are used, have agreed on concepts and definitions of terms that are most appropriate to these purposes, and have decided on the most suitable criteria for recognizing assets and liabilities and the best basis for carrying them in the financial statements, we shall be in a better position to resolve specific problems on a consistent and logical basis. For example, within such a framework of postulates and principles, we would no longer treat questions concerning tax allocation as isolated problems to be solved individually; deferred taxes would or would not be treated as liabilities, depending on whether their characteristics conform to the accepted general principles or definitions relating to liabilities. Similarly, questions concerning future tax benefits from loss carry-forwards, the effect of business combinations, long-term leases, and pension plans, would be resolved within the framework of postulates and general principles.

I believe the mere mention of some of these specific problem areas and of the current approach to them is sufficient to indicate both the potential benefits offered by the research program and the difficulties of attaining these benefits. As I said earlier, I believe a clear understanding of both of these aspects is the most important form of support the profession can give to its research program at this time.

Participation

The second form of support I referred to previously is participation in the program. The Accounting Principles Board and the Research Division earnestly solicit the views of individual members of the profession both during the research preceding the publication of a study on a particular project and after its publication. This is confirmed in the following excerpt from the statement by the Board concerning the studies on basic postulates and broad principles, which appeared in the May issue of *The Journal of Accountancy:*

> In the opinion of the Director of Accounting Research, these two studies comply with the instructions to the Accounting Research Division to make a study of the basic postulates and broad principles of accounting. Prior to its publication, Study No. 3 has been read and commented upon by a limited number of people in the field of accounting. Their reactions range from endorsement of the ideas set forth in the study of "Broad Principles" to misgivings that compliance with the recommendations set forth by the authors would lead to misleading financial statements.
>
> The Board is therefore treating these two studies (the one on "Postulates" and the other on "Principles") as conscientious attempts by the accounting research staff to resolve major accounting issues which, however, contain inferences and recommendations in part of a speculative and tentative nature. It hopes the studies will stimulate constructive comment and discussion in the areas of the basic postulates and the broad principles of accounting.
>
> The Board feels that there is ample room for improvement in present generally accepted accounting principles and a need to narrow or eliminate areas of difference which now exist. Accounting principles and practices should be adapted to meet changing times and conditions, and, therefore, there should be experimentation with new principles and new forms of reporting to meet these conditions. The Board believes, however, that while these studies are a valuable contribution to accounting thinking, they are too radically different from present generally accepted accounting principles for acceptance at this time.
>
> After a period of exposure and consideration, some of the specific recommendations in these studies may prove acceptable to the Board while others may not. The Board therefore will await the results of this exposure and consideration before taking further action on these studies.

The portion of this statement that I want to emphasize today is the following, which clearly indicates that the Board intended to encourage rather than to foreclose further consideration of the subjects covered by these studies:

> It (the Board) hopes the studies will stimulate constructive comment and discussion in the areas of the basic postulates and the broad principles of accounting . . . . After a period of exposure and consideration some of the specific recommendations in these studies may prove acceptable to the Board while others may not. The Board therefore will await the results of this exposure and consideration before taking further action on these studies.

I feel quite seriously that our research program brings us to a crossroad in the development of our profession. If its objectives are accomplished, it will be a tremendous step forward in client and public service and in professional stature. If it should prove to be only a superficial success, it would tend to inhibit further effort toward genuine progress for years to come. And if it should, through some unexpected circumstances, become abortive, it is not inconceivable that the latitude we have enjoyed to develop accounting principles within our profession might give way to government regulation. In short, I think we have passed the point of no return with our research program; we must see that it becomes a genuine success.

For this reason, I believe it is important not only that the best thinkers in our profession participate by offering their views and criticism, but that this be done constructively. None of us individually, nor the profession collectively, has anything to gain by damaging or destroying our own program through uninformed or unjustified criticism. However, I certainly do not mean to imply that constructive criticism necessarily means agreement; on the contrary, genuine disagreement is the essence of constructive criticism.

Constructive criticism, however, must be directed at specific matters, and preferably should suggest alternatives to the matters being criticized. Destructive criticism, on the other hand, ordinarily is expressed in broad generalizations and offers no suggestions for improvement. It appeals primarily to the uninformed and its nebulous character makes it difficult to refute on the merits of specific issues.

I hope we shall resist any temptation to characterize the studies on postulates and principles, or any of those that will follow, in sweeping generalities such as "too theoretical" on the one hand, or, "too pragmatic" on the other. The process of developing the postulates and principles envisaged by the research program is one in which abstract reasoning and logic can play an important part. The academic side of our profession can make an important contribution in this respect, both in the preparation of research studies and in subsequent constructive criticism of them. Likewise, the tentative conclusions expressed in the research studies must be subjected to the crucible of practicability by considering the problems that would arise in applying them. It is in this phase of the program that widespread participation by practitioners can result in the most useful contribution. We are now in the early stages of this phase, and meetings such as this one today are an excellent vehicle for stimulating constructive criticism by those engaged both in teaching and in practicing accounting.

At this stage, it is well to remember that inauguration of the research program did not mean we had abandoned the concept that accounting principles should be "generally accepted." Rather, it was instituted as a means of developing a coordinated system of postulates and principles that would achieve more general acceptance because their merit could be demonstrated readily. I believe practitioners should think of the research studies in terms of the practical effects of the proposals and the reactions they would expect in discussing the merits of the proposals with management, shareholders, bankers, underwriters, governmental authorities, and other interested parties.

For example, with reference to the proposed principle that would require price-level adjustments in financial statements, how convincingly could you explain its advantages over the presently accepted principle? Could you show actual or possible cases of misinterpretation or improper decisions resulting from the use of unadjusted carrying values? Could you point out areas of improvement or increased usefulness that would result from price-level adjustments? How would price-level adjustments affect present contractual arrangements such as loan agreements, and profit-sharing plans? What would be the effect of such adjustments on governmental regulation and fiscal and tax policies, security markets, product pricing, labor negotiations, and similar matters of public interest? On the other hand, how well could you defend the present use of historical dollars in the light of the well-known decline in their value and the resulting heterogenous accumulation of values in the balance sheet?

These questions illustrate the type of practical approach I believe practitioners must take in considering the proposals in the research studies. In probing these proposals, we should not assume that the old is necessarily good, or that the new is necessarily bad—or vice versa. But we should bear in mind that theory unable to stand the acid test of practice is not good theory, and that practice not compatible with sound logic and reasoning is not good practice.

CONCLUSION

I have already indicated the extreme importance that I believe attaches to the success of our research program. With respect to our profession's future I think it is not being overly dramatic to quote Thomas Paine's solemn reminder that "These are the times that try men's souls," or to use the more contemporary reference to an "agonizing reappraisal." Therefore, I sincerely hope that the profession will receive the studies on postulates and principles with an understanding of the vital importance of our research program and of the function of basic postulates and broad principles in it; that we will consider these studies critically but constructively on their merits in relation to the criteria mentioned earlier and that in doing so we will recognize that there is no fundamental conflict between *good* theory and *good* practice.

INTERPRETING THE BASIC ACCOUNTING POSTULATES

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The Basic Postulates of Accounting by Dr. Maurice Moonitz, Director of Accounting Research of the American Institute of Certified Public Accountants, was published in the Fall of 1961. This was the first "product" of the Institute's research program as organized under the Accounting Principles Board. It was intended to precede the companion research study on broad accounting principles published in the early part of May, 1962.

The purpose of the postulates study and its companion study on principles was to provide a platform or foundation for the pronouncements of the Accounting Principles Board on accounting matters. The postulates study was a logical first step. There existed a considerable lack of agreement on terminology concerning the underlying supports of accounting principles. Are they postulates, axioms, assumptions, conventions, or propositions? Such lack of agreement clearly extended to the question of identifying the "postulates," and determining their number. The record showed no substantial or sustained effort to establish the underlying assumptions. Furthermore, the number of unresolved accounting problems and the record of their persistence as unsolved problems suggested that accountants were far from certain in their own minds about the underlying assumptions or assertions on which principles rest. Very possibly much of the argument and disagreement about principles could be attributed to a lack of agreement on more basic issues. Starting with a postulates study seemed indeed to be a logical first step.

The authoritative status of the research study on postulates is indicated by the Foreword to that study: "Accounting research studies are designed to provide professional accountants and others interested in the development of accounting with a discussion and documentation of accounting problems. The studies are intended to be informative, but not conclusive. They furnish a vehicle for the exposure of matters for consideration and experimentation prior to the issuance of pronouncements by the Accounting Principles Board . . . . The conclusions and recommendations have not been approved, disapproved, or otherwise acted upon by the

Accounting Principles Board, the only agency of the American Institute of Certified Public Accountants having authority to make or approve public pronouncements on accounting matters." Clearly, the postulates study (or any subsequent research study published on the authority of the director of accounting research) does not indicate the official position of the Institute. It is not intended that such studies be given a cloak of authority. Nor is it intended that such research studies are the last word on the various subjects.

Before attempting a brief description of the study and the postulates it proposes, I want to acknowledge my appreciation for the difficulty of the task assigned to Moonitz. If it had been our job to author such a study, where would we have started? How philosophical would we have made it? How many pages would we have used in supporting reasoning? Would we have used an ethical approach? Would we have stressed the pragmatic aspects of accounting? I am grateful to Moonitz for his willingness to undertake such a project as this.

The report of the American Institute's special committee on research provided a basis on which to start. The committee asserted its belief that postulates are necessarily derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. Moonitz described his approach as follows: "We must choose a starting point, determine how much of the environment we are to explore, and decide on a way to proceed. Of the possible approaches considered, the one with the most advantages and the fewest disadvantages is to focus on the question: With what kinds of problems in the economic or political environment do accountants concern themselves?" (page 2) Of course there were other approaches available, but who is to say the approach selected was wrong? This is the kind of question that inevitably arises in connection with a profession's efforts to make progress. In a sense the answer to this comes slowly and is made apparent by the acceptance on the part of accountants, evidenced by written and oral reactions and use or adoption of the position taken.

The decision to explore as much of the environment as relates to the problems that accountants deal with gave the author a principle of selection to use when studying the economic and political environment in which accounting operates. The relevant part of the environment was considered under the chapter title "The Environment of Accounting." And as we might have expected, the following are some of the environmental characteristics noted by Moonitz that influence accounting:

Goods and services produced are, for the most part, distributed through exchange of some sort, and not consumed by the producers.

There is a need to make economic decisions.

The necessity to make economic decisions creates a need for quantitative data.

We have an orderly society.

We have private ownership of most productive resources.

We have "free" labor (in contrast to slave labor).

Wealth may be accumulated by individuals and their institutions.

Money is used.

The discussion about the characteristics of the environment in which we conduct our "business" affairs furnishes the basis for the first set of propositions, for convenience identified as the Group A postulates. They are listed below:

A-1. Quantification. Quantitative data are helpful in making rational economic decisions, i.e., in making choices among alternatives so that actions are correctly related to consequences.

A-2. Exchange. Most of the goods and services that are produced are distributed through exchange, and are not directly consumed by the producers.

A-3. Entities (including identification of the entity). Economic activity is carried on through specific units or entities. Any report on the activity must identify clearly the particular unit or entity involved.

A-4. Time period. (Including specification of the time period.) Economic activity is carried on during specifiable periods of time. Any report on that activity must identify clearly the period of time involved.

A-5. Unit of measure (including identification of the monetary unit). Money is the common denominator in terms of which goods and services, including labor, natural resources, and capital are measured. Any report must clearly indicate which money (e.g., dollars, francs, pounds) is being used.

The consideration of the economic and political environment establishes the need for and a potential usefulness of what we know as accounting. Quantitative data are needed to support economic decisions. Such data relate to the resources of business entities and changes therein. There is a need to measure and report the consequences of business decisions. Some sort of accounting process is inevitable, and the following propositions emerge from this recognition.

B-1. Financial statements. (Related to A-1.) The results of the accounting process are expressed in a set of fundamentally related financial statements which articulate with each other and rest upon the same underlying data.

B-2. Market prices. (Related to A-2.) Accounting data are based on prices generated by past, present or future exchanges which have actually taken place or are expected to.

B-3. Entities. (Related to A-3.) The results of the accounting process are expressed in terms of specific units or entities.

B-4. Tentativeness. (Related to A-4.) The results of operations for relatively short periods of time are tentative whenever allocations between past, present, and future periods are required.

The third and final group are referred to as "imperatives." They assert what "ought to be" rather than "this is the way things are," which characterizes the A and B postulates. The C group is presented below.

C-1. Continuity (including the correlative concept of limited life.) In the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely. In the presence of evidence that the entity has a limited life, it should not be viewed as remaining in operation indefinitely.

C-2. Objectivity. Changes in assets and liabilities, and the related effects (if any) on revenues, expenses, retained earnings, and the like, should not be given formal recognition in the accounts earlier than the point of time at which they can be measured in objective terms.

C-3. Consistency. The procedures used in accounting for a given entity should be appropriate for the measurement of its position and its activities and should be followed consistently from period to period.

C-4. Stable unit. Accounting reports should be based on a stable measuring unit.

C-5. Disclosure. Accounting reports should disclose that which is necessary to make them not misleading.

Considering the study as a whole, the reasoning and discussion supporting the postulates show no lack of scholarly or writing ability on the part of the author. The length of the study represents a good compromise between being so thoroughgoing and meticulous as to discourage busy accountants from reading the complete text and being so brief as to provide inadequate evidence of the author's approach and reasoning. As to the postulates themselves, they can not be criticized on the score of restricting accounting principles to the conventional list. In this regard, consider Postulate B-2. "Accounting data are based on prices generated by past, present, or future exchanges which have actually taken place or are expected to."

This was interpreted at the 1961 annual meeting of the American Institute as permitting the abandonment of cost as the primary basis of accounting measurements. The position taken in the study is that accounting measurements should be based on the broader concept of any "objective" measurement. This is borne out by postulate C-2. "Changes in assets and liabilities . . . should not be given formal recognition in the accounts earlier than the point of time at which they can be measured in objective terms."

Objectivity is conceived of as being attainable by more kinds of evidence than a completed transaction. I certainly am not carrying any banner advocating the abandonment of cost. In fact, I have many misgivings about such "objective" concepts as current replacement cost and appraisal information. Nevertheless, I think our postulates should be broad enough to permit change and evolution in our accounting principles. So I am not a critic of the postulates because they are designed to be capable of supporting accounting principles that are unfamiliar or unacceptable as of now.

As noted earlier, the postulates of the C group make assertions about what ought to be. The assertion that should cause some discussion is C-4. ("Accounting reports should be based on a stable measuring unit.") For many, many years our accounting textbooks have referred to the monetary postulate in such phraseology as: "Fluctuations in value of the monetary unit may properly be ignored"; or, if stated as an assumption: "For accounting purposes it is assumed that the monetary unit remains fixed." The assertion that accounting reports should be based on a stable measuring unit seems, at first reading, to represent quite a departure. Some readers will probably interpret this postulate as asserting that accounting should seek to measure the consequences of purchasing power changes. I do not place such a drastic interpretation on the assertion.

As I read the research study, certain factual questions must first be explored before application of the postulate would necessitate any changes in reporting practices. Moonitz cites two questions as illustrative of such conditions precedent: (1) Has the U. S. dollar been so unstable as to warrant the use of some other basis? (2) Are the methods of measuring instability reliable enough to warrant the introduction of a new basis of measurement? Of course, the research study reveals Moonitz's personal preference in this matter, but I interpret the postulate as permitting us to consider, to explore, and possibly to evolve with respect to the price-level matter. I think this is but another example of the previously mentioned desirable and commendable feature of the postulate in that they are not restrictive; they will permit change; they will not contribute indirectly to inflexibility.

The task of interpreting the postulates is a broader assignment than merely commenting on the meaning of the wording used in stating the postulates. The implications of the several postulates can be determined by any of us by reading them. Of perhaps greater interest is the matter of appraising the preliminary reaction to the postulates. In a sense this is also interpreting the study in terms of its impact and potential effectiveness.

The Institute has given wide exposure to the postulates study and has encouraged individuals and groups to express their views on the conclusions and recommendations contained in the study. Consequently, reactions have been forthcoming. Of course, in appraising preliminary reactions we should make allowance for the rather natural tendency to find something unsatisfactory about the work of a researcher in a field in which we are also expert. With this in mind, here are some of the reactions that have come to my attention.

Perhaps the most significant reaction to date centers around the comments of Leonard Spacek, who was a member of the project advisory committee for the postulates study. (The members of a project advisory committee are appointed by the Director of Accounting Research, with the approval of the chairman of the Accounting Principles Board, to consult with the Director and the staff assigned to the research project. A project advisory committee reviews the plan of research in its early stages, acts as a sounding board for conclusions reached by the staff, and reviews the draft of the report to advise the Director as to its suitability for publication as an accounting research study. Each member has the privilege of commenting on any part of the study.) His comments were published with the research study. As I understand Mr. Spacek's comments, he believes that the historic and customary approach to the formulation of a basic foundation and framework of accounting theory is not adequate and that a completely new approach is needed. He interprets the Moonitz study as taking the historic and customary approach, with the result that the so-called postulates set forth are merely self-evident observations that cannot serve as the basic foundation on which sound accounting principles can be established. To quote Mr. Spacek: "The essential prerequisite to the establishment of a sound framework of accounting theory must be a clear determination of the purposes and objectives of accounting . . ." His view is that the one basic accounting postulate underlying accounting principles is that of fairness to all segments of the business community.

The assertion that the research study does not adequately describe the real purpose and objectives of accounting is not easily disposed of, but it may be a criticism more appropriately directed to the Accounting Principles Board than to the research study. Perhaps the Accounting Principles Board should have attempted to set forth the real purpose and objectives of accounting as a guide for the research studies. Assuming that the Board had made such a project its first undertaking and had been able to issue a statement of purposes and objectives of accounting, I have some reservations whether it would have provided as much guidance as Mr. Spacek and his sympathizers believe would have been the case. Notions about such matters as real purposes and objectives are inevitably set forth in such broad, philosophical language as to produce as much interpretation difficulty as if no statement had been issued. To illustrate this difficulty, consider the objective of "Fairness." This is a pretty nebulous concept. As one accounting professor recently commented, fairness is a philosophical concept related to the concepts of truth and justice and is not definable except in relation to a specified set of circumstances. The question of what is fair can be given a definitive answer only by resorting to negotiation or litigation. The professor concluded that philosophical concepts do not provide firm bases for accounting principles. Others have asked in reaction to the fairness postulate, fairness to whom? Some accountants are of the opinion that the concept of fairness is a basic moral or ethical way of life, is presumed to be present in accounting, and that it should not be necessary to state the concept of fairness as a postulate. In the research study Moonitz considers such ethical concepts as justice, truth, and fairness and agrees that in a field such as accounting these concepts and their implications cannot and should not be ignored. But, to quote Moonitz, "A major disadvantage attaches to them. Terms such as justice, truth, and fairness designate subjective concepts which themselves need standards to be capable of application. Ultimately, the results of any purposive human activity must be judged in the light of the value judgments inherent in ethical concepts. They are not satisfactory, however, as a point of departure for an objective inquiry such as this one. (Referring to the postulates study page 3), I judge that a number of accountants agree with the fairness postulate, but I believe that there is an impressive number of accountants who fail to see in the fairness concept the kind of platform alleged by Leonard Spacek.

To move along, some accountants have reacted to the postulates with no trace of enthusiasm, expressing an attitude that the list of postulates does not represent much of an accomplishment. This attitude can be characterized as follows: "I didn't find anything in the postulates that I wasn't already aware of." It is probably true that many accountants expect that research effort should produce something new, even revolutionary. When the results are couched in well-known or familiar-sounding assertions, reaction at best is one of lack of enthusiasm. Such a reaction does not disturb me. After all, accounting postulates should be self evident to accountants. If the postulates were viewed as startling, earth-shaking, or revolutionary, there would be more basis for concern.

Some negative reactions relate to the way in which the researcher went about his task. I consider a reasonable amount of disappointment about the way the study was managed to be normal and not indicative of anything serious. One of the characteristics of a profession is a lack of quick unanimity or endorsement of the results of "research" effort.

I have also heard the following appraisals, stated briefly:

The study is too theoretical.

We still lack agreement on the definition of a postulate.

The A postulates are trivial.

Some of the postulates are really principles.

Some of the assertions are reporting standards, not postulates.

There is an apparent unevenness of quality and significance in the postulates.

However, it would be most unfair to conclude that on balance the reaction has been unfavorable. I have encountered an encouraging quantity of favorable comment. Unless one stops to realize that in many cases the unfavorable reactions are confined to one or two or a few small points, there is danger in understanding the support. It is also true that negative comment is more likely to be communicated within the profession than is favorable comment.

I think it is also true that it is somewhat unfair, or at least premature, to evaluate the postulates in isolation. The postulates are put in a better position to be judged when they can be considered along with the companion research study on broad accounting principles. As noted, the companion study was released only last week. Professor Mautz of the University of Illinois, in an unpublished communication made available to the Accounting Principles Board, states this point in an excellent fashion. I quote: "To a considerable extent, the propriety, usefulness, and adequacy of postulates must be judged in terms of the theory structure which they support. Like the foundation of a house, its strength or weakness may not be apparent until the structure is completed. Postulates standing alone do not lend themselves to critical evaluation."

The title of the just published research study on accounting principles is: *A Tentative Set of Broad Accounting Principles for Business Enterprises*. The authors are Robert T. Sprouse and Maurice Moonitz. Thus, the "package" is now available for evaluation. In this connection it may be desirable to recall some quotations from the Charter Rules of the Board as adopted by the Council of the Institute:

> The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles, for the guidance of its members and of others. This means something more than a survey of existing practice. It means continuing effort to determine appropriate practice and to narrow the areas of difference and inconsistency in practice. In accomplishing this, reliance should be placed on persuasion rather than on compulsion. The Institute, however, can, and should, take definite steps to lead in the thinking on unsettled and controversial issues.

The Accounting Principles Board has expressed its hope that the studies will stimulate constructive comment and discussion in the areas of the basic postulates and broad principles of accounting. It acknowledges that accounting principles and practices should be adapted to meet changing times and conditions, and, therefore, there should be experimentation with new principles and new forms of reporting to meet these conditions. However, the Board did express its belief recently "that while these studies are a valuable contribution to accounting thinking, they are too radically different from present generally accepted accounting principles for acceptance at this time." The Board is therefore awaiting the results of exposure before taking further action on these studies. It is now up to us to participate in this effort to make progress in clarifying the theoretical structure of accounting by thinking about the principles and postulates, by talking about them, and by letting your reactions be known to the Accounting Principles Board.

DOES ACCOUNTING HAVE A SOLID FOUNDATION?

GEORGE R. CATLETT, C.P.A.
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In the present missile and atomic age, our free enterprise system is undergoing many changes. Accounting and the resulting financial statements are playing an increasingly important role. What are some of these changes that are taking place?

Financial statements are used by various segments of our society (such as stockholders, managements, creditors, employees, governmental agencies, customers and potential investors). Each of these groups has, in varying degrees, conflicting interests which are much more significant today than they were 25 years ago. At one time, stock ownership and management of many companies were closely related, and the family-type business was common, even among relatively large companies. A trend has been occurring toward professional management (with relatively small stock ownership) and toward a wide dispersion of stock ownership in publicly held companies. Today there are 15 million such stockholders. A survey of the New York Stock Exchange shows that in 1959 one out of every eight adults owned stock in publicly held companies, whereas there was only one out of 16 in 1962. American Telephone and Telegraph Company has 2 million stockholders, and General Motors Corporation has 900,000 stockholders.

An increasing amount of money is being borrowed to finance business, with debtors and creditors having more of an impersonal relationship. Labor organizations have grown much stronger and claim to have a direct interest in the financial reports of companies with which they bargain. Governmental bodies in the field of regulation have increased their authority. Many millions of potential investors are being urged to invest in American business.

Thus, it is readily evident that accounting is more important today than it has ever been. A great many more people are relying on financial statements for a much wider variety of reasons. Has accounting and financial reporting kept pace with the needs of our society? In my opinion, it has not, and considerable evidence can be cited to support this conclusion. More unsolved problems exist in accounting today than at any time in the past. The reason for this situation, in brief, is the lack of an authoritative and coordinated structure of accounting theory that is needed as a guide to business men and to public accountants. What kind of a foundation does accounting actually have today?

Generally Accepted Accounting Principles

The logical place to commence our consideration of this question would seem to be an analysis of the concept of "generally accepted accounting principles." This term is used throughout accounting literature, legal documents, auditors' opinions and reports to stockholders as if everyone knew what it means.

Many of you probably have children in school and have the same experience we do in our family. The children frequently come home and say that they want to do something or buy something because "everyone else" is. Whether you know it or not, there is an organized conspiracy among children to obtain what they want by using the "everyone else" routine at the same time. The only effective weapon I have been able to find is merely to reply "name three." This generally stops them cold. Naming three accounting principles that can be defended as such may be difficult for each of you also.

Some time ago, I decided that it might be worthwhile to make a real effort to find out what generally accepted accounting principles are. In order to go about this in a methodical fashion, the logical place to begin seemed to be—what is meant by generally accepted? One prominent accountant has said that "everyone" knows what this means. This must be everyone except me.

The first question would seem to be—acceptance by whom? A well-known author in this field states that general acceptance results only from authoritative support by those best qualified to render accounting judgments. He did not bother to elaborate on who these people are.

Some persons say that the bulletins issued by the former Accounting Procedure Committee of the American Institute of Certified Public Accountants have represented the best evidence of general acceptance. The difficulty in the case of these bulletins is that they were directed more to accounting practices than underlying principles, and each bulletin contains the statement that the authority of the bulletin rests upon its subsequent acceptability.

Others argue that general acceptance means actual usage in business and industry. Who can state what the accounting principles are that underlie the various practices being followed today?

After spending considerable time on the "by whom" phase and not getting any place, I decided to go on to the question of how much acceptance is required—in other words, acceptance to what extent? Almost everyone agrees that general acceptance does not require majority usage, but there seems to be no common understanding at all as to how much acceptance is required. If there is any measuring device available, I do not know what or where it is.

The accounting profession has been following the most unusual type of circular logic—that accounting principles are sound because they are accepted and they are accepted because they are sound. You can get dizzy thinking about that reasoning. You might also consider a question: "If financial statements must be prepared in accordance with generally accepted accounting principles, how can financial reporting be improved to meet changing conditions and new requirements if it is limited to accounting principles and practices that are already generally accepted?"

My conclusion after completing this phase of the study was that general acceptance must merely mean that "everyone is doing it" except no one knows who "everyone" is any more than our children do. This would be humorous if it were not so serious.

After being somewhat frustrated with respect to my investigation of "general acceptance," it took some determination to approach the other half of the problem—what are accounting principles? Since accounting is more of an art than a science, it might be argued that the term "accounting principles" is misleading and creates the wrong impression, because it sounds like fundamental truths or indicates a precision that is not actually present. This term could be changed, but there does not seem to be a better alternative available, and any substitute that would convey the idea that there is less of an authoritative basis for accounting might not adequately serve the desired purpose. Therefore, any argument over words can be passed by, because what we are talking about are the objective standards and the underlying concepts that accounting either does have or should have.

A great deal has been written about accounting principles. In fact, if you put all the books, articles and theses on this subject in one pile, they would reach from the floor to the ceiling of this room several times. With all of this information available, one would assume that several first-class accounting principles could readily be found.

After reading and studying for a period of time, and after eliminating a considerable amount of excess verbiage, I have come to the conclusion that this indeed is a very fuzzy subject. What we have today for accounting practices actually are a group of customs that have grown up over many years—some of these are outmoded; some are inconsistent as between each other; and alternative practices with widely differing results are followed for the same kinds of transactions. Our so-called principles, as they are found in accounting literature, have generally been arrived at by a reverse type of logic, by taking practices that have grown up as customs and rationalizing back to principles, rather than first establishing the proper principles and then judging the practices against such standards. This is somewhat like the factory time clerk who called the local telephone operator each day to get the correct time, when the telephone operator was setting her clock by the factory whistle every morning.

Conventions and Doctrines

There is another group of conventions, doctrines or whatever you might choose to call them that have had a significant effect on both accounting principles and practices. Yet, they should not be classified as postulates or principles. The most important of these are conservatism, consistency and disclosure.

Conservatism is a philosophy or attitude. Accountants have generally considered conservatism to be a prime virtue, and it is a desirable characteristic up to some reasonable point. However, numerous examples of overconservatism could be cited. Also, conservatism is only relative. This is evident from the fact that what is conservative to a creditor may be misrepresentation to a selling stockholder.

One fact that is sometimes overlooked is that conservative accounting may result in a nonconservative income statement at a later time. Costs and expenses that are applicable to future operations and are incurred for the purpose of producing income in subsequent years are in many instances charged off currently because of a conservative custom or because there may be no positive indication that they will be recovered. Thus, costs are not matched with revenues that are produced as a result of such costs.

Accountants have put considerable emphasis on consistency, since this is important if comparisons of financial statements are to be made from year to year and if trends are to have any significance. Some accountants take the position that the choice among various alternative practices is not as important as the consistent application of the practices selected. This viewpoint may almost result in the contention that it is all right to be wrong, as long as you are consistently wrong.

Financial statements and related footnotes should disclose any significant information necessary for a proper understanding and evaluation of the financial statements of a business enterprise. In other words, there should not be a failure to disclose any material facts required to make the financial statements not misleading.

The concept of adequate disclosure of significant data is, of course, commendable. In some instances, however, this has resulted in many complicated footnotes that are technically correct, but many of them are not particularly informative or understandable to the average reader. Disclosure has its place in financial-statement presentation, but it is not a substitute for proper accounting in the first instance.

Viewpoint of the Public

Sometimes it is argued that the public is not demanding any great change in accounting—everyone seems to be satisfied, so why get excited and rock the boat? However, the public does not know many of the facts, and its acquiescence has lulled the accounting profession into a false sense of security.

In the area of published financial statements, it should not be necessary for readers (1) to analyze the "fine print" of voluminous footnotes or technical parenthetical comments, (2) to understand the effect of many alternative accounting practices applied to similar situations, or (3) to know the effect of significant factors not reflected, before they can be certain whether the figures in financial statements represent a fair presentation of the facts and really mean what the reader has a right to assume that they do.

The financial statements issued by business enterprises are the reports and representations of the managements. Thus, the managements have an important responsibility in the area of accounting principles. Accountants in industry must continually work for improvements that will produce an accounting that is fair to all segments of our society. However, most corporate mangements are not interested in crusading or experimenting in the field of accounting principles. And, so long as a wide variety of alternative customs and practices is available (and considered to be "generally accepted"), they frequently will be used to produce the desired results, and the accounting will tend to deteriorate to the lowest common denominator.

Public accountants must take an active part in the development of sound accounting principles, since they have an important responsibility to the public and to all segments of the business community insofar as their opinions on financial statements are concerned. Public accountants are in the positions of impartial scorekeepers. Their opinions must be based on proper and fair standards.

Basic Postulates of Accounting

Professor Miller has discussed the nature of accounting postulates as well as the specific list of postulates proposed by the American Institute's Director of Accounting Research.

There is one question that we might well ask ourselves—are postulates, such as these, necessary, desirable or effective in the development of accounting theory? After giving consideration to this subject, I am becoming more convinced than ever that the accounting profession, through its attempt to develop postulates, is trying to force an approach in theory development that is essential in some fields of knowledge but is not particularly applicable to accounting. Most accounting postulates are unverified assumptions, irrelevant or harmless rationalizations, obvious conclusions, or unrelated matters that have not had any significant effect toward the development of sound accounting principles and practices; and it is doubtful that they ever will have.

An example of a postulate that seems to be on everybody's favorite list is the one that financial transactions can be most meaningfully stated in terms of money. I would not argue against this; in fact, it is a waste of time to talk about it. Theoretically, the financial statements of corporations could be stated in bags of potatoes or loaves of bread, but this is so remote as to be foolish.

The postulate with respect to continuity represents the "profound" concept that if the evidence indicates a business has an indefinite life, this viewpoint should be followed; but if the evidence indicates a business has a limited life, then that viewpoint should be followed. It would not be very sensible to do anything else, because in either case the facts determine the course of action.

The so-called postulates of "consistency" and "disclosure" have no place as a part of the basic theories followed in the determination of accounting principles, because they relate entirely to the application of such principles.

An analysis of most of the proposed postulates reveals their ineffectiveness, but the time available does not permit a discussion of the other ones.

There may be a place in accounting theory for postulates, but they certainly do not represent the foundation upon which to develop sound accounting principles and practices for use in our every-day work. This is demonstrated by the two studies on basic accounting postulates and broad accounting principles published by the American Institute's research staff. These two studies together are supposed to represent a solid foundation upon which a coordinated structure of accounting theory can be erected. In my opinion, they will prove not to be satisfactory for this purpose. Time available today does not permit further explanation of my view in this regard, but I could demonstrate in some detail that the authors of these studies started at the wrong point and followed the wrong road. This has nothing to do with whether or not I agree with their conclusions.

What Is Needed for a Foundation of Accounting Theory?

The proper place to begin would seem to be an analysis of what accounting is and why we have it. Accounting principles or any other aspect of accounting theory is not inherent in nature or anyplace else. Accounting has been developed by man over a great many years to accomplish certain objectives. These objectives are considerably different than they were 50 years ago, or even 25 years ago. Accounting must continually change to meet the needs of our society, and the only reason for its existence is to meet those needs.

Therefore, the cornerstone of the foundation of accounting must be a clear, comprehensive and accurate statement of the purposes and objectives of accounting. If this were established, then the problem becomes one of determining what constitutes a combination of theories to best accomplish these purposes and objectives. This seems so elementary that it has generally been brushed aside as inconsequential or considered in a superficial manner. However, in my opinion, the accounting profession (including the American Institute's research staff) is trying to decide *how* something should be done before a decision is reached as to *what* it is trying to do.

I have looked through a considerable volume of literature (although not all of it by any means) and have never found a satisfactory statement of the purposes and objectives of accounting, written in such a way it could serve as a clear-cut guide of what is needed. Most of the descriptions of the functions of accounting deal with the recording, classifying, summarizing, and reporting of data. They do not include anything as to *why* we have accounting or *what* we really are trying to do. They start right off with *how*. Transactions are not recorded or resources are not measured just to be doing something. The *reasons* for doing these things should have some bearing on *how* they are done.

"Fairness" as an Over-all Standard

Have you ever given any serious thought as to the purposes of accounting and the resulting financial statements that are used by persons other than the managements of companies? One viewpoint you might consider is that accounting should result in financial statements that are fair to all segments of the business community (management, labor, stockholders, creditors, customers and the public), determined and measured in the light of economic and political environment and the modes of thought and customs of all such segments—to the end that the accounting principles based upon this standard shall produce financial accounting for the lawfully established economic rights and interests that is fair to all segments.

Principles should be formulated to serve as a framework of reference for the solution of problems. The test of fairness would not be used to solve these problems. It would be used to develop and test principles that would produce fair results when applied to problems. Fairness in this regard involves much more than a matter of personal opinion, since the factors that produce fairness must be clearly and logically demonstrated on a professional and authoritative basis. The reasoning behind each principle would be stated in detail and supported by logic, facts, evidence and analysis in considerable depth. This was never done by the American Institute's Committee on Accounting Procedure in its publications. Other guides would also be developed to implement the principles, and these would be used in solving everyday problems. Here again, the reasoning would be given in detail.

Thus, the individual accountant would not be applying "fairness" to problems. There would still be plenty of need for professional judgment in evaluation of facts and in arriving at appropriate conclusions in any individual case. The accounting profession needs a yardstick that is fair and not one made out of rubber that is of various lengths for different accountants or for the same accountant as applied to different companies.

Let us consider, as an example, the question of whether the change in the purchasing power of the dollar should be recognized. This should be covered at the "principles" level. I believe it can be conclusively demonstrated by thorough and careful reasoning that to present the facts fairly to all segments of society, such change in purchasing power must be recognized. Therefore, a principles could be logically developed and clearly supported, and the methods of implementing it could then be established.

Conclusion

The accounting profession is facing the most critical period in its history. Straight thinking and prompt action are required. Merely because accountants are involved with double entry bookkeeping does not mean that they should become victims of double talking and double thinking.

Many of the arguments relating both to the defense of present accounting practices and to the proposals for improvements are about as clear as the order given by the Army sergeant to a group of recruits who had been given a military problem: "Line up alphabetically according to size, and we will proceed to solve the solution."

The accounting profession has a great responsibility to establish accounting principles that will best meet the needs of our society. This requires looking forward and not backward. First, we must have a clear idea of what is needed, and second, we must have the courage and desire to accomplish the necessary objectives.

SECOND SESSION

Thursday, May 17, 12:30 p.m.
Ohio Union—West Ballroom

Presiding:

William B. Nicol, c.p.a., *President, The Ohio Society of Certified Public Accountants*

Presentation of The Ohio Society of CPA awards to the highest candidates in the May and November, 1961 CPA examinations, made by:

Harry C. Lyle, c.p.a., *Member, Accounting Education Committee, The Ohio Society of Certified Public Accountants; Assistant Professor of Accounting, The Ohio State University*, to: Donald J. Schappacher, Robert Allen Schachter, Joseph Earl Carrico, Robert James Kennedy

THIRD SESSION

THURSDAY, MAY 17, 2:00 P.M.
Ohio Union—Conference Theater

Presiding:

ROBERT J. MAINS, *President, Public Accountants' Society of Ohio; Partner, Robert J. Mains & Associates, Dayton, Ohio*

Paper: "Management Information Systems—An Evolution"

WILLIAM J. BATES, *International President, Systems and Procedures Association; Director, Methods and Procedures Division, Commercial Department, U.S. Steel Corporation, Pittsburgh, Pennsylvania*

Paper: "Fallacies in Long-Range Planning"

JAMES DOWD, *Cresap, McCormick and Paget, New York, New York*

Paper: "Operational Auditing"

JAMES A. ROBBINS, *President, Federal Government Accountants' Association; Deputy Chief, U.S. Army Audit Agency, Washington, D.C.*

MANAGEMENT INFORMATION SYSTEMS—AN EVOLUTION

WILLIAM J. BATES
Director, Methods and Procedures Division
Commercial Department, U.S. Steel Corporation
Pittsburgh, Pennsylvania

It is widely recognized that we are in the midst of an evolution in data processing and information handling which is developing at such a pace that it might more properly be called a revolution. Although great changes have taken place in recent years, many of them almost beyond belief, there is reason to conclude that developments have scarcely reached their full potential. As a part of this revolution, the advances in information systems are rapidly outdating the old concepts of mere data processing and are expanding under the larger framework of the total systems concept.

There have always been information systems so that the notion of such a system is not entirely new. As far back as 480 B.C., history tells us that the Greeks, in defending themselves against the invasion of the Medes and the Persians, had an information system regarding their defense against the tremendous Army and Navy sweeping across their territory. The information system of that day consisted of word of mouth and to the extent it was written it was frequently carved in stone or on some early form of paper. Through the development of civilized man, communications appeared in the form of hand-written documents, then crude printing, which led to printing in more highly developed form. The path leads us to punched cards, punched tape, and other automatic methods of data collection into the present era of electronic and automatic data collection, manipulation and dissemination.

The extent and complexity of the information system used and required in the past and even today depends upon the requirements of the enterprise. In a small partnership the work might be split between the partners and much of the information system is word of mouth with a few basic records. In a somewhat larger concern, more written records are considered necessary and these, in most cases, are primarily historical in nature. In larger operations, including commercial, government and military, it becomes increasingly necessary to have a wide variety of information collected, recorded, and available to meet the requirements of management. Thus, information systems have evolved much as the needs of management have dictated, aided, of course, by advances in the techniques of information handling.

Before we consider management information systems any further perhaps it would be well to define just exactly what the term means for the purpose of this discussion. It means a pulling-together, or perhaps it might better be called a synthesis, of the information needs of individual executives and managers at each of the various levels of an enterprise whether commercial, military or government. In a very sophisticated system the entire needs of an enterprise might be included, but typically a management information system would include the information for a particular cycle of information flow such as an order system or a particular inter-related accounting requirement.

I would like to stress that the mere existence of some type of data processing program within a company—whether limited or extensive—will not in itself provide all of the elements of a successful management information system, although it certainly will help. A successful management information system must contain at least three basic elements. The first and perhaps most obvious is the use of data processing equipment. This usually involves computers and other appropriate electronic input and output devices necessary for the rapid collection, manipulation and tabulation of data. The second element which is desirable in at least the more extensive information systems is the use of rather highly developed communication links between the electronic computers and the input and output devices so that data can be conveyed from one machine to another. This is often referred to as machines talking to each other, since the data are all in machine language at that stage. The third, and I feel most important, element is the proper selection and arrangement of information for planning and control. It is basic that an effective information system must give each manager the facts he needs, when he needs them, and in the form in which he needs them for decision making. He does not want a great mass of information which is not germane to the particular problem on which the decision is to be made.

Without question one of the major contributions of data processing and modern business systems techniques is that of facilitating the decision making process. A management information system contributes to decision making by providing accurate and timely information to the manager with which to measure more exactly the economic and operational consequences of a decision.

One of the principal tasks of management is to make decisions and to make them based on the best information at hand. Lacking good information the manager may hope to compensate and still arrive at a satisfactory conclusion by relying upon experience and judgment. Increasingly managers are finding that their work is moving from an art to something more closely approaching a science. Aiding this change is the development of effective management information systems.

Along with the development of these information systems has been a somewhat parallel development in the form of a study of decision making. Many new tools have come into this field, among them the application of mathematics. However, in all cases the collection, manipulation and dissemination of information in some form are involved. There are several schools of thought as to the long-range effects upon management positions and ability to make decisions as these new tools evolve. Some believe that many decisions will be made almost automatically and that much of business will be conducted without benefit of the guidance of middle management and perhaps even some members of top management.

Clearly there have been tremendous strides made in the technology that bears upon management information systems of various types as well as with respect to the electronic and automatic equipment used in such systems. However, I do not think that managers will be outmoded. Decisions might be considered as falling into one of two general categories. The so-called structured decision which is composed of identified, articulated and quantified elements capable of being manipulated in a rigorous manner. The second type is the so-called unstructured decision which does not bear the characteristics just described. To some degree it seems reasonable that automatic machine controlled answers can be contrived in the case of the structured decision, but human judgment is necessary in the case of the unstructured decision.

As managers move ahead into the 1960's they will find that in dealing with their tasks they will be employing to a large extent the same tools that they are using today. The managers will also find that they are expected to know, understand and handle new management concepts and tools. They will also be expected to use systematic methods of analysis in decision making supplemented by the new and more effective tools of communication, computation and presentation. While managers are certainly not going to be displaced as a group—actually their number and importance will grow with the years—the developments in the management sciences, such as operations research and decision making logic and the new electronic tools and systems of information handling are going to make a difference even to the manager in the small business.

From the many statements that occur repeatedly in modern systems literature it seems clear that management has a strong desire and need for information systems. However, it is not quite that easy. It would appear that the ability to produce data or information may have outrun that ability of management to assimilate the information. There have been numerous examples in which incredible amounts of information have been produced on modern electronic equipment and presented to management expecting that they would somehow find the needle of pertinent fact in the haystack of irrelevant information. What is needed obviously is a planned system of business intelligence—or as we have been calling it a management information system which selects, rejects, edits and headlines business information—in short, which turns data into business intelligence.

The ability to produce information and the knowledge that the information must be meaningful to the manger is not enough. We still know relatively little about the process of decision making and not nearly as much as perhaps we should about the information required by managers to make decisions. Even our present relatively limited knowledge of the decision process in organizations indicates that any attempt to view it solely as a system of information processing can be grossly misleading. A complex interplay of human attitudes and values is involved in the information processing task. For example, on a particular problem, accounting, sales finance and production might share both complementary and conflicting interests in a series of decisions. If that series is viewed as naked and purposeful information processing, the substitution of mechanical for human processing devices is likely to yield unexpected, often unsatisfactory results.

It is natural to conclude that the common objective of all managers is to reduce costs and increase profits. However, managers with functional responsibilities may have radically divergent ideas about the definition of the costs or profits with which they are concerned. Progress of the concern as a whole does not guarantee ready acceptance by managers who live within a system of rewards and penalties and who are dependent upon positions in the organizational structure.

There is also the normal factor of human resistance to a change. This factor will contribute to slowing of acceptance of a system which depends heavily upon machines and which may carry with it in the mind of the manager a vague but possibly worrisome threat to his particular sphere of influence.

These are some of the considerations that tend to make the development of management information systems an evolution rather than a revolution. However, in spite of these seeming handicaps it is possible to design, install and operate a successful system in either a small or large concern. There are perhaps at least five key points that should be considered before such a system is developed. These are:

1. Establish the long-range objectives and then work out a basic design for the information system that will enable the concern to operate more effectively and at a lower cost with respect to the area being covered in the system.
2. Study, analyze and define the information system currently in use. All companies have information systems in use, some of which are quite sophisticated.
3. Make such short-range improvements in existing system as are consistent with the long-range plan, thereby getting some immediate advantage.
4. Set up a timetable and assign appropriate responsibility for attaining the long-range objectives.
5. Carry out the plan.

The key part of this program and the real creative aspect will be the development of a new information processing system that will meet the desired specification.

If the objectives of the information system resulting from the study are to be realized then there must be a step-by-step plan. In some cases, this could well mean the discarding of many traditions and taboos if the maximum benefit is to be derived from an integrated systems concept. It is even possible that some conventional, organizational functions as they are known at the time the plan is started may be modified or even eliminated because it might result that there are no longer lower level or decision making people involved in performing the functions in question.

Because systems design to a large extent is dependent upon equipment and/or the techniques used to transmit and process information there is a natural but rather dangerous tendency to select equipment—frequently a computer—which is presumed to be capable of carrying out the information processing need and after that, design the system to utilize the capabilities of the machine. Clearly this puts the cart before the horse and limits the ability of the systems designer to devise an information system that will serve the needs of management at all levels.

One additional thought along the lines of systems design. Every company has a number of information systems in existence. Changes in existing systems should only be made when it has been determined that the new system and the associated equipment are compatible with the requirements of future business conditions.

Today more often than not data referred to as management information is really information regarding people rather than things and issues. Information can be considered as management information only to the extent to which the manager needs or wants it. It is significant to him only in terms of its relation to his accumulation of relevant knowledge and plans and to his personal responsibility. In considering data processing systems I feel it is a cardinal mistake to consider them apart from the management information systems which they serve. Its true worth is a function of what comes out of it and that in turn is a function of what went into it. Management information systems then represent one of the truly dynamic tools of modern management—one that is destined to receive a great deal more attention in the years immediately ahead as the evolution continues.

The most successful managers will take steps to strengthen their understanding of the capabilities as well as the limitations of the new technologies. Only in this way can they maintain the knowledge they need in order to apply the techniques, successfully use the new class of professional experts as a powerful administrative resource, and secure the appropriate and necessary balance between management as a science and management as an art.

In the years immediately ahead, management information systems as an aid to management will increase in effectiveness and sophistication as managers and systems experts are able to match technology and need. The road will not be entirely smooth and there will be false starts and, unfortunately, a number of painful experiences. Over-all, however, this new tool will become of increasing benefit and importance to managers in commercial, industrial, military and government organizations.

FALLACIES IN LONG-RANGE PLANNING

James Dowd
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Historically, man has been a long-range planner. From the days of primitive agriculture to the present he has shown concern for the future, always looking ahead, anticipating the good, dreading the bad. This concern found elaborate expression in his religions, with their emphasis on a day of judgment and the hereafter. Whether he was a simple farmer, counting the days from sowing to reaping, or a Joseph in ancient Egypt with his pre-New Deal agricultural plan for storing seven bumper crops against seven dust bowl failures, or one of our contemporaries, whose year-old infant has already been registered for prep school and college —wherever we look, we find this universal phenomenon of planning.

Historically, in business, too, man has been a long-range planner. The entrepreneur, the owner—the company president—has traditionally exercised this function. In more recent times, however, as corporations have grown, this function has been increasingly performed by the financial-accounting executive, a staff executive possessed of the records of the firm (and nowadays of its computers as well), possessing the over-all corporate point of view in contrast with sales, production or R & D, and obsessed with making profits and saving money—really an ideal man for the job. Or so it would seem.

Thus, it is decidedly appropriate that a group of financial and accounting executives consider certain aspects of long-range planning.

Before we explore some fallacies in long-range planning, a few definitions may be helpful:

Fallacy — that which deceives the eye or mind (and as we shall see, both the eye and the mind are susceptible to deception in long-range planning).

Long-range — five years, ten years, a quarter of a century or more, depending on the type of industry and the needs of the corporation.

Planning — stated simply, a managerial activity or function concerned with future operations. It is probably the most difficult aspect of any executive's position, and it is certainly one of the most important problems of top management.

Perhaps the outstanding fact about long-range planning is that there still remains considerably more to be discovered about it. It is a manysided problem. It is complicated by possibilities, it is fraught with unknowns, it is handled (we must admit to ourselves in all humility) by human beings of varying degrees of inexpertness. Small wonder, then, that sound guides for future action are so hard to come by.

Perfect planning is a myth—or an unusual stroke of luck. It is far safer for management to recognize the limitations inherent in any long-range planning, and to battle against fallacies in its thinking, than to assume that it is doing a good long-range planning job.

A professor of medicine does not apologize to his students because there are as yet no cures for certain types of cancer, nor does this fact prevent him from discussing the related symptoms. After all, it is important that his students be able to distinguish between benign and malignant tumors.

So today, in considering long-range planning, we are going to explore symptoms of fallacies in the hope of learning whether our long-range planning is malignant or benign—or, more frequently, somewhere in between.

Accordingly, let us consider ourselves directors of a corporation attending a board meeting which is devoted to long-range planning. As directors, we are supposed to be more than merely intelligent men, each with our respective fund of specialized knowledge and experience. We are supposed to be wise men, exercising more than our usual objectivity, common sense and intuition. We will want to ponder at some length before we judge the evidence regarding long-range planning, because the symptoms may be difficult to detect and interpret.

In attempting to judge the worth of our corporation's long-range planning, let us as directors first consider the symptoms of *who* is involved in long-range planning.

The answers can, of course, vary:

—Only the president
—The president and his vice presidents
—A committee with representatives from various departments
—A separate planning department.

Since any of these answers can be benign or malignant, we have to probe deeper. Our concern here is with the talent and the time devoted to planning.

In a corporation of any considerable size, the president could easily be swamped by this task. Even vice-presidential time, particularly if it is spent in actual researching and working up data, is costly. Far better to delegate time-consuming pencil work to a committee of middle management, *if* they have the time and *if* all the important functions of the company are represented on this committee.

And as for the full-time planning department, be it one man or a dozen, is it staffed with a well-rounded "comer" in the corporation, or has a convenient pasture been found for a "goner," or for a "loner" who does not get along with the rest of the company and may therefore be presumed to be somewhat out of touch and without access to the confidences of his colleagues? *There* is a malignant symptom.

As directors, we are properly concerned not only with who has had a hand in long-range planning, but *how*.

I think we would begin to get a sinking feeling if a company officer said, "Some of us did it in our spare time." But again we need to probe deeper: How many executive man-days does this nicely bound long-range document represent? Were there frequent conferences between the planning committee and top management, or just a few? And now that this document has been produced, has the planning committee thankfully disbanded? Attitudes are all-important to us; as directors, we know that planning is a difficult and often thankless task. And so we pay attention to the president and listen between the lines.

Has he properly emphasized from the start, and on suitable occasions thereafter, the importance of long-range planning to his entire executive staff? Was there a formal announcement, or merely a few lines in the employee newsletter? Were any of the committeemen relieved of their regular assignments, or any of their duties transferred to others? We may not be in a position to frame, however politely, questions like these to our president, but we think them just the same.

In particular, we must be aware of any connotation that this nicely bound document "constitutes our long-range planning." The document is a *plan*, but planning is *not* a document. It is an activity; it is a continuing affair and not an event. Therefore, we listen for possible hints that our corporation's executives think the job is done, that the plan has been completed, or that next time, "I hope they get someone else to work on that project." The word "project" is quite a clue. It suggests you do the planning and get it over with. It is like lashing down the helm, abandoning the bridge, and expecting the ship to cross the ocean and make port.

If we find no evidence that periodic reviews of the long-range plan are contemplated, we might begin to suspect the quality of the work as well as the caliber of our management.

And now, let us look at the document itself. Did it have to be a hundred pages thick? It is not that we directors are lazy, but how can one say so much about the future? How reliable, or even worth reading, is this document? How many executives in our corporation are going to wade through this—refer to it as a guide in their regular work?

Let us suppose our Vice President-Finance has put this out. His staff economist has picked up a couple of long-range forecasts of gross national product (GNP) made by well-known authorities; our sales are related to GNP and *voilà* here is our long-range sales forecast.

That may seem just a little too pat for us, so we ask the Vice President-Sales if the sales in each of his product lines are growing at the GNP rate or at different rates. The answers here may be revealing. Different rates, are they? Some declining? Some industries' use of certain product lines declining? And the export market is more and more of a problem? And a major competitor has just come out with a new line which appears to have wide customer acceptance? Do we have a new line coming out? When? Indefinite?

Let us also pursue some related points. How is the industry as a whole going to fare while our sales are growing *à la* GNP? And our major competitors—will they get bigger? Are mergers likely? How about price cutting? In other words, what is the probable competitive environment five or ten years from now?

You will recognize that this is a far different and far more qualitative approach than the usual quantitative statement of a long-range sales forecast. It is more enlightening because it poses some questions. What future problems are likely to be in store for us? What is this long-range plan disclosing or intimating?

Leafing further through our document, we discover that the sales forecast has been used as the basis for projecting detailed statements of profit and loss, source and application of funds, balance sheet, earned surplus and financial ratios, for each year covered by the long-range plan. All of these statements are supplemented by comparative historical data exhumed from our corporation's past.

We examine the direct cost-of-sales figure and discover that it bears an unvarying relationship to sales. We inquire about the variation in cost of sales by product line and about assumptions regarding future product mix. We look at the factory burden figure and see that it is inching ahead in the future as in the past. We ask the Vice President-Production about possibilities for automation, about his need for new machinery, his opportunities for changes in production lines and quality control techniques and inventory methods. We inquire about labor relations and product development work.

We learn quite a bit, but we have difficulty relating what we have learned to that sterile cost of sales projection. We are told that there are too many imponderables, no exact schedule for modification of production facilities, no advance information on forthcoming union demands, in fact, we are given every good reason why those cost-of-sales figures are what they are, and incidentally, why we should distrust them. The clincher comes when we are told, "After all, these are only projection." *Only?* That old question of attitude comes back to haunt us.

And this is the crux of Fallacy Number One: Is our management giving lip service to long-range planning? Are they going through the motions of what they feel is proper corporate ritual for a "progressive, modern management?" Are they mistaking the form for the substance? Is this physical, tangible, nicely-bound document their idea of what long-range planning is?

Then, as we scan the pages of supporting schedules, the further thought occurs to us that this is primarily a *financial* document—an attempt to portray as faithfully as possible what our future P & L's and balance sheets may look like. A planning document which is devoted to this approach may possess some usefulness—like the Coast & Geodetic Survey's publication of tide tables for various points along the sea coast. But tide tables do not shed much light on the problems of hurricanes and floods and navigating past hidden shoals.

What executives need is something less figure-happy in the way of a long-range plan, with much more emphasis on contingencies, with the spotlight on potential opportunities as seen today, and possible catastrophes or handicaps to the business. What is the imminence of these opportunities and handicaps, and what is their significance to the executives in purchasing and production and research and sales?

This brings us to Fallacy Number Two: Is the corporation's long-range planning practical? Is the planning document useful as a regular guide to middle as well as top management?

It is the *pertinence* of the document to the present activities of the corporation that gives it value in helping to shape these activities toward the future. But if the long-range plan is disconnected—if it portrays some bright never-never land, automatically arrived at by following the line on the graph, then you are liable to hear some harried middle management executive ask, "If things are going to be so good, why don't I feel better? Why have I got all these problems?"

Of course, too often planners dwell in ivory towers. This brings us to a consideration of Fallacy Number Three: Just how *real* is this long-range planning document?

All of us remember the advertisements appearing during World War II, promising the bright future once the shooting was done. Good for morale, good publicity for companies with no consumer products to sell, but very optimistic, very unreal. Never a hint of post-war problems, personal or public. Fellow directors, I suggest you beware of long-range planning which does not identify basic problems for our industry and for our corporation.

However, let me take you now quickly to Fallacy Number Four.

If we read in our long-range plan about problems and prospects, and if we substitute for 1965 or 1970 the dates 1955 or 1960, and if the statements we read still seem appropriate, then we do have a symptom of malignancy on our hands: the projection of the present business climate into the future.

All we have to do to spot this particular symptom is merely to review in our own minds how many changes have taken place in the past five or ten years in our company, in our industry, in our customers, in business generally. Long-range planning requires the contribution of an informed imagination, grounded in historical perspective, or our plans will simply lag. We will not be able to anticipate, we will be continually taken by surprise, and our executive decisions will be purely reactions to competition and circumstance, rather than a display of initiative and foresight.

The essence of long-range planning is devising a strategy for the business over the coming years—not prescribing yesterday's tactics for tomorrow. Without the new and the different, there is no opportunity for the element of surprise. In business, as in football, there is a need for the new and the different in order to be successful.

But, fellow directors, what do we find in our corporation's long-range planning? Evidence of surprise and excitement? Or symptoms of fallacies?

Are our executives giving lip service to the need for long-range planning but acting on the basis of business as usual? Is long-range planning a fad around here?

Do the long-range plans have practical significance for influencing the thinking and the current decision-making of our middle as well as our top management?

Are our plans realistic? Are problems as well as opportunities identified? Or have the plans been put together in a vacuum?

Related to these questions is another one: Are there any valid projections of the business environment? Or are these projections just rehashes of the present and the past?

As a matter of fact, let us begin to ask the management of our corporation just how good their *short*-range planning is. How well are they managing their annual budgets and operating programs? Is their market research really good? And how about management development? The best of plans still need good people to translate them into reality. Are enough good people coming along in the junior management ranks?

And this reminds us: How about the statement of company objectives? Do we have any? Are they more explicit than merely "to make money?" Do they make good sense?

All of these things: annual budgets and programs, market research, management development, company objectives, are essential foundations for good long-range planning.

Planning takes thought, rather than paper. Planning takes daring, rather than ritual.

"Unfortunately, often," says Professor Beveridge in his remarkable book, *The Art of Scientific Investigation*, "committees are too inclined to play safe and support only projects which are planned in detail and follow conventional lines of work. Worthwhile advances are seldom made without taking risks."

He was writing, of course, about laboratory research, from which new products spring, but his words apply equally to long-range planning committee deliberations.

Big volume and major projects are not the answer to long-range planning. I have seen one sheet of 8½″ x 11″ paper express a valid and illuminating long-range plan, because there had been previous broad-gauge thinking about the future, and because there was initiative and because there was appetite for opportunity.

As directors, let us take a hard-boiled look at this top management crowd we have around here. Do we see evidence of intelligent drive on their part? Or just energetic treadmilling? Do we see evidence of entrepreneurial instinct, of an appetite for the calculated risk? Or are these boys in love with traditions, with pictures of "our founder" all over the place, and a good retirement plan? Private enterprise is a wonderful thing, but when the emphasis gets put on the *private* instead of the *enterprise*, we have a problem on our hands.

No effective long-range planning is possible in an atmosphere like that, because fundamentally, long-range planning is an attitude, a state of mind.

Fellow directors, I move that we give the management of our corporation one year to shape up—or resign.

OPERATIONAL AUDITING

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Introduction

Mr. Chairman, ladies and gentlemen of the 24th Annual Ohio State University Institute on Accounting. The Federal Government Accountants Association and I, as its President, are indeed honored in being invited to participate in this Institute's proceedings. We like to think that such an invitation gives recognition to the vast improvements and forward steps that have occurred in financial management in the Federal Government and to the part that the Federal Government Accountants Association has played in this progress.

I believe that accountants and auditors in Government can look with pardonable pride to past accomplishments; however, if we are to keep pace with the ever-changing world, we must continue to seek ways of improving our accounting methods and techniques. The factor that is drastically—explosively—of primary concern is the rate of change. The world is changing so rapidly that we cannot train our personnel to meet a given situation, rather we must have people educated and basically trained to cope with whatever changes may occur. Some people say there are only three things about the future that are certain.

1. It won't be like the past.
2. It won't be like what we think it is going to be.
3. And the rate of change will be faster than ever before.

Perhaps the major dilemma facing both industry and Government today is the managerial lag in keeping pace with rapid developments. Problems are being created at a much faster pace than our managerial skills are being improved to cope with these problems. The managerial lag will never be corrected until we adopt a positive, dynamic attitude toward the solution of managerial problems, and we are all part of management. This aggressive attitude in tackling a problem was perhaps well illustrated in a recent interview with the manager of a missile project. When asked about his missile he replied, "It is really very simple. All I have to do is fly to the moon, pick up a rock, bring it back, and place it on the President's desk, but you would be surprised at the technological problems I bump into."

It seems to me that those of us in the auditing field of accounting have a tremendous opportunity to play a vital and positive role in today's management, whether it be in industry or in Government. However, if we are to do this, it means coming down off the high stool and taking off the green eye shade.

Omar Khayyam's Rationalization of Drifting

Some 3,000 years ago, while in his usual condition of inebriation, an early-day Persian beatnik tentmaker named Omar Khayyam analyzed life in a Rubaiyat in terms of whence—why—whither. His attitude was well summed up in his musing, thus:

"And that inverted Bowl / they call the Sky,
Whereunder crawling coop'd / we live and die,
Lift / not your hands / to It / for help—for It
As impotently moves / as you or I."

This was a fatalistic point of view. That is—man does not control his destiny to any degree. Therefore, no use in worrying—have another cupful and enjoy the ride, regardless of whence it might have come, or why, or whither it might go. This was clever rationalization for another cupful—and for going along with the ride wherever it might drift. However, it did not get many tents made.

Influencing the Tide of Affairs

While we might deplore Omar's apparent easy resignation, there is a quality involved in his questioning of whence, why, and whither. We humans are so constituted that we must question and improve the lot of man. Even cynical Omar helped revise the calendar of his day. Most of us cannot afford Omar's comfortable rationalization of inactivity—nor do most of us even want to. The free ride is worth exactly what it costs. We like to think we are at least influencing—if not controlling—the direction of the ride.

In the modern idiom, I believe we have "had it" as far as the "whence" of auditing as we have known it is concerned. It is important only in analyzing the "why" and in projecting the "whither."

I think this is true in terms of the concept of audit of the so-called "outside auditor" or public accountant as well as, if you will, the "inside auditor" or internal auditor.

I believe the day will come when the public accountant will be required to evaluate the management whose results of operations are reflected in the financial statements. It seems to me that if a stockholder is to rely on the disclosures in a financial statement he should also have assurance that the management is an efficient one. This is to say—the financial statement may truly reflect the current financial conditions, but the caliber of management may be such as to be leading the company down the road to disaster. However, I shall leave this phase of the subject to persons more learned in this area and confine my remarks to what we term internal auditing.

Today, any individual whose position involves the use of an adding machine or the verification of figures is often called an internal auditor, and his duties are termed internal auditing. It is somewhat analogous to calling a draftsman an architect because both use a slide rule.

The Institute of Internal Auditors defines internal auditing as the independent appraisal activity within an organization for the review of the accounting, financial, and other operations as a basis for protective and constructive service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls. What does this definition mean to you? (1) Does it cover those tasks which are in fact part and parcel of the operating accounting functions, such as the reconciliation of bank accounts and the verification of receivables and payables, or the validation of payrolls? (2) Does it contemplate an audit function limited in scope to the accounting books and records, and primarily directed toward verifying the accuracy of data recorded in such records? (3) Does it contemplate an audit function limited in scope to the areas of financial management, such as financial policy making, budgeting, accounting, reporting, and so on? Or, (4) Does it envision an audit responsibility having no limitation in terms of the organizational boundaries subject to review?

In answering my questions, it seems to me to be necessary to bear in mind a key phrase in the definition and that it is—"as a basis for protective and constructive service to management."

To me, the audit I referred to as being part and parcel of the accounting operation would not fall within this definition; nor would the second responsibility, which is confined to the auditing of books and records. No doubt there are many who will disagree with me. But this merely emphasizes the lack of a clear understanding of what is meant by the term "internal audit." In my opinion, the verification and reconciliation process, of itself, is of limited value to management, assuring little else except that the accountant has properly arrived at the answer "four" in adding two plus two. Inventory records, for example, and the general books of account may be accurate and reconciled, and inventory balances as stated in the general accounts may agree with the actual inventories on hand. The accounting records may be accurate over-all; but what if the cost of procurement is excessive, and the method of handling, storing, and issuing inventories is unduly costly? Conceivably, the auditor could express an opinion that the financial statements fairly reflect the financial condition of a company, or a Government unit, with respect to which the supply management practices were so costly as to represent a serious threat to the continued financial stability of the concern or Government unit. To know that the accounting data had been accurately recorded and reported would be cold comfort to the supply manager or general management, in such circumstances.

The third type of audit, limited to the more or less direct areas of financial management, might or might not be a service to management. This would depend upon the restrictions placed upon what constitutes financial management. If, for example, the review of budgeting were limited to determining that basic data were accurately incorporated in the budget, I would say "no." If the reviews were to include the evaluation of the soundness of budget planning, etc., I *might* say "yes."

Undoubtedly, audits of these types are a service to management in varying degrees. However, in this ever-changing world where the "new" today may be outmoded tomorrow, I believe an audit function can best serve management if it has no barrier in terms of organizational boundaries subject to review, and has as its purpose the independent, objective, and constructive evaluation of the effectiveness with which resources are utilized. I believe this is what we should mean when we refer to management or operational auditing.

I believe an attempt should be made to classify the varied scopes of internal audit work. Perhaps we could call that type of audit basically limited to verifications and generally in the financial management area *Financial Internal Auditing*, and that concerned with an evaluation of the effectivenesss with which resources of all kinds are used company or agency wide *Operational Internal Auditing*.

What should be the approach to such an audit and what would be some of the areas of coverage and the audit objectives? Normally, the approach to such an audit would be through the organizational chart, functional statements, and procedural directives, then through the financial statements or books of account. Some of the areas subject to audit coverage might be:

1. *Organization.* A review of the organizational structure, including staffing, would be made for the purpose of evaluating its effectiveness as a means of management control and a medium for efficient and economical operation to assure the most advantageous employment of available resources and capabilities.

2. *Review of Planning and Programming.* The objective of this review would be to determine whether the annual programs developed were consistent with approved over-all master plans for production and the utilization of facilities and personnel.

3. *Budgeting.* The over-all objective of the review in this area would be to determine not only that the budgets prepared were accurate as to computations, but also that the intent of the over-all policies for production and future development were complied with, and whether commitment and obligational authority had been assigned in accordance with the budget plan.

4. *Funds Control and Management.* The purpose of the examination in this area would be to evaluate how well the funds available were being controlled and managed.

5. *Research and Development.* One of the significant program objectives would be to determine whether engineering change orders resulting from research and testing were being transmitted to production promptly and accurately.

6. *Procurement.* The objective of the audit in this area would be to evaluate:

a. The adequacy of control over procurement funds.

b. The reliability of procurement records and reports.

c. The effectiveness and timeliness of pre-award surveys and the adequacy of negotiations conducted.

d. The effectiveness of contract administration, including:

(1) Inspection procedures.

(2) Timeliness of implementation of engineering changes during production.

(3) Control and causes of excessive rework and revisions.

7. *Supply Management and Stock Control.* Examinations would be made of the methods used to determine stock requirements, the accuracy of the computation of reserves, the accounting procedures for maintenance of records on stock, the reporting procedures and forms used for reporting such stocks, and the accuracy of recorded inventories.

Concept of Operational Auditing

Let us pursue a single transaction or series of transactions under this concept of audit and see what we would do. I would like to lean on my Government background and experience to illustrate. However, this example, with possible changes in terminology, would apply also in industry.

All Federal Government agencies receive their funds through an identical process, that is, the submission of a budget to the Congress, the appropriation of funds by the Congress, the apportionment of these funds to the agencies by the Bureau of the Budget, and the allotment of funds by the operating agency to various organizational units to secure personnel, services, and supplies.

Agency "A" has decided to procure certain items of equipment and certain parts to support that equipment. Supply studies are made to determine the quantities needed, and where, and when. Funds are appropriated by the Congress and eventually allotted to a procurement office to obtain the materiel. A contracting officer seeks sources of supply and negotiates a contract with contractor "X." The estimated amount of the contract is "obligated" on the books of Agency "A." The equipment and spare parts are produced over a period of time and accepted by the Government. In turn, these items are sent to various storage locations and eventually issued for use. Here we have a series of actions, each of which has direct relationship to another. The following processes would be involved, but not necessarily in the order mentioned:

Determination of need
Budgeting
Funding
Method of Procurement
Production
Accounting
Receipt and inspection
Handling and storage
Inventories
Issues and shipments
Use of end items

In the circumstances stated, under an audit scope limited to the accounting or even the comptroller area—the auditor might conclude that the general accounts were accurate and reconciled, and that the inventory balance stated in the general ledger agreed with the actual inventory count.

Now let us examine the possibilities under the same set of circumstances, under the concept I term "Operational Auditing." In reviewing the computation of requirements, the auditor might discover that, if accurate data had been used, the procurement might not have been necessary or not necessary in the quantities contracted for. If a questionable contract is still in effect, the auditor could be instrumental in having it terminated for the convenience of the Government, thus saving the Government money and possibly avoiding the build-up of excess supplies. In the same general area, the auditor might observe that an item, after being issued for use, had to be disposed of as surplus because the item was of inferior quality or could not be used because of other conditions which may have been the fault of the producer. These conditions would undoubtedly prompt a complete inquiry into the procurement, perhaps resulting in recoveries from the contractor.

Further, in analyzing the contract during the audit of contractor "X," the auditor might have surmised that certain components the contractor would buy to produce the end item were on hand and available in the agency's inventories. If so, the auditor would extract a list of the items and request assist audits to determine whether (1) the items were in the agency's inventory, (2) any of the items were excess to the agency's needs, and (3) the items were being disposed of as excess.

These conditions may exist with respect to several items being procured. For example, some of the same items being procured could have previously been disposed of at only a fraction of the original cost, while others could be awaiting disposal action. Upon a full disclosure of this information, the contracting officer could negotiate an amendment to the contract to permit the furnishing of the items as Government-furnished material at significant savings to the Government.

Although the individual situations cited would be important in themselves, the objective of the audit would be to measure the efficiency of performance of specific departments or other functional units of the organization.

Up to this point I have been discussing operational auditing as it might apply within a Government organization. Now I would like to briefly review the trends discussed and the application of this concept to an audit of a contractor's operations, that is, to an audit of a contractor doing business with the Government under a contract where cost is a prime factor in the reimbursement to the contractor.

Historically, the Government auditor, in such cases, ascertained whether costs claimed by a contractor had actually been incurred and, if so, whether the costs were allocable to the contract. The audit results were expressed in an advisory report to the contracting officer, in which report an opinion was expressed as to the costs which should be allowed or disallowed.

Today, the trend of contract auditing within the Government is to deter the incurrence of unnecessary, excessive, or unreasonable costs, rather than to recommend a disallowance of costs after the costs are incurred. Consequently, the audit is directed toward an evaluation of the contractor's pricing proposals, operating plans, programs, budgets, and management decisions.

Let me cite two examples of audit techniques which are geared to accomplishing these objectives.

The first decision that a contractor must make in performing under a contract is what parts, assemblies, and components are "in-house," and which of these items he will buy. Let us say, for example, that a contractor without any experience in manufacturing air conditioning equipment, which is required as a component for the contract end item, decides nevertheless to manufacture it. His decision was motivated by the desire to gain experience and "know-how" in this area and also to utilize idle facilities. In such a case, the auditor would review the proposed decision to manufacture and if the auditor concluded that to manufacture would result in unreasonable costs, he should recommend to the contracting officer that this decision not be approved, and that the contractor be directed to buy. I suppose that the contractor's decision to manufacture would be in the interests of the owners of the business, but it would definitely not be in the interests of the Government.

Let us take a look at the areas of the hiring and utilization of personnel. We are all aware of the heavy competition today for engineers. Few auditors are qualified to evaluate engineering matters; however, there is much that we as auditors can do. For example, we can be concerned with manpower controls; that is—Is there a well defined and supported plan under which "X" number of engineers are hired? What budgeting controls exist in this area? How does the contractor decide how many engineers are needed on each project? Once the decisions are made, what controls exist?

Where contractors exercise effective manpower controls, good opportunities exist for maintaining reasonable cost levels. On the other hand, unrestricted and uncontrolled labor hiring leading to over recruitment and hoarding of personnel necessarily results in expenditures in excess of reasonable cost levels.

Time does not permit me to delve further into this subject. Suffice it to say that audit effort directed toward preventing costs before incurrence can save the Government more money than hundreds of auditors could save the Government through retroactively questioning costs already incurred.

Staffing Requirements

I think it well to point out that, once the auditor examines into areas of operations outside those related strictly to accounting, he will not find the sign posts and well-marked road maps that he finds when making audits directed toward expressing an opinion on financial statements.

What then are the staffing requirements for such a task? Must the staff be comprised of engineers, lawyers, procurement and supply experts? I think the answer is "no." I believe the accounting graduate, properly trained in the audit concept and thoroughly indoctrinated in the operations of the activity or enterprise to be audited, offers the highest potential.

Why is the accountant particularly fitted for this type of work? I think it is because his education has impressed upon him the importance of accuracy—that a set of figures cannot be half right, it must be completely right. He learns the importance of obtaining adequate documentation to support a conclusion. He is less inclined to accept what he sees on the surface, and is more apt to have a desire to go deeper to see if things really are as they appear on the surface.

In addition to having technical qualifications, the auditor must be a diplomat and a salesman combined in one. He must be tactful but firm, and have the patience of "Job." He should have the ability to express himself clearly and concisely, both orally and in writing, and to do so in a manner that will not antagonize. He cannot be the penny-pinching type, but must have the ability to distinguish between the significant and the trivial. Above all, he must be management-minded. This means objectively placing himself in the position of the decision-maker at the time the decision was made. It is very easy to criticize or second guess management six months or a year later, when you have information which was not available at the time the original decision was made. It is when an auditor fails to recognize this fact and attempts to second guess management that he becomes a hindrance to management and ceases to serve a constructive purpose. It is difficult, but nevertheless imperative, to analyze a situation as it existed at the time of the decision—to relate conclusions to current facts, and to develop recommendations which will be helpful to management in future operations. If the auditor and his work are to be accepted, professional standards of confidence, reliability, and objectivity must be met.

Reporting

The degree of acceptance of the audit report determines the success or failure of the audit mission. People do things well when they are sold on an idea themselves, rather than when they are directed to accept it by higher authority. This applies to the recipients of audit reports. Therefore, the preparation of the report requires careful consideration and attention. The format is of the utmost importance.

Precedent usually dictates a "finding-recommendation" method of presentation. It is amazing how the word "finding" in a report can arouse the antagonism of the reader. I suppose one associates the word with a judicial pronouncement. However, this type of format does not foster enthusiasm for acceptance of the product. There are alternatives, however, which have a tendency to gain greater acceptance. Two of these are:

1. The "problem-solution" approach.
2. The "background information—statement of conditions and conclusions" approach. Under this concept an attempt is made to properly prepare the reader, for example, as to the complexities or magnitude of the operation being reported on. This is helpful to the reader.

Timeliness of the report is important. It is often said that there is nothing more stale than yesterday's newspaper, and I think the same is true of late audit reports. An audit report loses significance and value in direct proportion to the time between completion of the audit and submission of the report to those who can take action. This should be no more than 30 to 40 days after completion of the audit.

Another requisite is getting the information across to the reader. An excellent audit may have been made but, if the report issued is not interesting and informative, the efforts in performing a good audit will go down the drain.

The twin essentials of effective reporting—clear writing and promptness of submission—present a difficult hurdle and frequently the two seem incompatible. The task of presenting conclusions in the report, and in acceptable format, is sometimes more difficult than the performance of the audit.

A good audit report will be concerned only with matters of materiality. Significant information may be lost if the report is cluttered with matters which are not significant from the management viewpoint. I admit that it is often difficult to distinguish between matters which should be presented in the audit report, and those which should be called to the attention of the proper authority but do not warrant inclusion in the formal audit report.

Frequently, accountants and auditors have a tendency to express themselves in technical terms that the readers of the report, who are not accountants, may not understand. If an auditor does not get his story across to the reader, he cannot expect him to understand what needs to be done and to take appropriate action.

The report should be complete, clear, and concise, but with sufficient pertinent facts and examples to support the conclusions reached. Every conclusion should show the cause of deficiencies reported and the actual or potential adverse effect on operations.

All comments on conditions as they are developed should be discussed with the client, whoever he may be, and agreement should be obtained at least as to the facts. Agreements cannot always be reached as to the conclusions and recommendations. In these cases, I believe that the reasons for nonconcurrence should be clearly and objectively stated following the conclusion, together with the auditor's views on the nonconcurrence.

The last and perhaps most difficult objective is a stimulating, cogent summary. I believe that the summary should be one of the first sections of the report. It should not be a mere rehashing of the individual statements in fewer words, but should be a broad evaluation of the performance of the functions audited with a brief synopsis of the noteworthy observations and recommendations. The summary should be directed toward arousing the interest of the busy executive who would at least read one or two pages of the report. By this means he may become sufficiently interested to continue reading the complete report. In any event, it should permit him to grasp the significance of what is wrong and what needs to be done. The primary objective should be to get the audit story across to him in relatively few words.

It is hardly necessary to acknowledge that there is something in the old saying "there is nothing new under the sun," and so I do not view this concept as something no one has thought about or actually implemented in the past. However, I do believe that we in Government are somewhat ahead of our friends in industry in application of the concept.

Thank you.

FOURTH SESSION
BANQUET

THURSDAY, MAY 17, 6:30 P.M.
Ohio Union—East Ballroom

Presiding:

ARTHUR D. LYNN, JR., *Assistant Dean, College of Commerce and Administration, The Ohio State University*

Remarks:

GEORGE W. TRAUTMAN, honoring George W. Eckelberry, retiring *Professor of Accounting, The Ohio State University*

Paper: "Taxes and Economic Growth"

G. L. PHILLIPPE, *President, General Electric Company, New York, New York*

TAXES AND ECONOMIC GROWTH

G. L. Phillippe
President, General Electric Company
New York, New York

Thank you for this opportunity to address such a distinguished gathering of accountants.

As was mentioned, I have only recently departed from your ranks—fallen from grace, some of you might say. And while I find my relatively new responsibilities to be endlessly challenging and stimulating, the demands are such that I sometimes feel a little like the mathematician who dreamed he was a negative number under a square root sign and could not get himself out. For that and many other reasons, I am always glad to be at home again among old and new friends in the accounting profession.

It is also a pleasure for me to have this particular rostrum from which to speak. In the first place, Ohio is an especially important state to the General Electric Company. We have a total of 29 plants in this state—more than in any other state—and employ upwards of 25,000 people here. In addition, the last time we counted, we had over 20,000 share owners of record in Ohio.

Finally, I always feel it highly appropriate for General Electric people to take every available opportunity to come to a leading campus such as that of The Ohio State University. In the technologically dynamic industries where we see our future unfolding, it is critically important to our competitive capability to find and attract top-flight young manpower in scientific, technical and managerial fields. This is one reason why our company has sought close ties with the educational community. In this respect, our experience is similar to that of the business community generally, in coming to a greater awareness of its interdependence with education.

This evening I would like to touch lightly on a subject which is currently in the spotlight of public policy debate, a subject in which—if you will all join me in a little self-indulgence concerning the public responsibility of our calling—the accounting profession has an opportunity to make a needed contribution to public policy: taxes—and the relationship between taxes and economic growth.

The Federal tax system has caused many headaches over the years, of course, but we should never forget that it has also brought a great boom in demand for the services of accountants, as well as tax lawyers and experts on the location and dismantling of stills. Perhaps the job opportunities we owe to this system add to our responsibility to comment on its economic effects and on proposals for change and improvement.

Revision of the tax laws has become a leading topic of public policy discussion. Spokesmen for the Administration, many business executives, academic students of tax matters, and many other qualified observers agree on the importance of tax reform, especially in light of the new emphasis on economic growth and expansion.

Of course, the job of tax reform is not going to be accomplished in one all-encompassing, perfectly-written tax law. Rather this complex job must be worked at in manageable and politically possible portions over the years.

Right this year, however, certain important proposals for tax reform have been very much in the news. In the current session of Congress, one major set of tax proposals has already passed the House of Representatives and is under active consideration in the Senate right now. Another more fundamental set of proposals is also being prepared by the Administration. Other proposals are also receiving more than usual attention.

Not since the last major revision in 1954 has the opportunity for fruitful and meaningful tax reform appeared to be such a distinct possibility, though not yet a probability. On the other hand—and this fact is just as significant—it is clear, from some of the proposals advanced and from the discussion of them, that confusion over ends and means makes forward progress by no means automatic. Exchange of views and working toward clearer understanding is needed.

So much has been spoken and written on the specifics of tax proposals that perhaps the best contribution we might make today would be to step back a little and see if we can reflect on what it is we really want the tax system to do. If we can get these basic objectives in focus, perhaps the sound and fury over specific proposals can be made to signify something.

What are the fundamental characteristics of a "good" tax system? Do we want it solely to raise revenue? Or do the people generally want it also as a mechanism for incentive to, or control of, the private enterprise system? Is it an instrument to encourage growth—or a deterrent? How can we best devise a tax system to have the least drag on the private enterprise system and the greatest encouragement for growth? Half a dozen general guidelines could be set up.

One requirement is that the system produce the necessary revenue.

Equity is unquestionably another prime requirement. No tax system can succeed if it is irrationally discriminatory or offends the taxpayers' belief that they are being treated reasonably, fairly and equitably.

A third basic objective is, all other things being equal, simplicity. As any harassed individual taxpayer can tell you on the morning of April 16 of any year, simplicity in the tax system is greatly to be desired. With tax rates as high as they are, some complexities are inevitable in the interests of equity. But have the high rates caused so many complexities and special provisions, so many inequities that the administration of our tax laws is becoming too burdensome? Are we providing an unreasonable incentive to tax avoidance by interpretation of language that creates a squirrel cage of rulings, laws and administrative decisions?

Consistency over time is a fourth general objective of importance. Here I have in mind particularly the problems in business decision-making which may be posed whenever there exists a situation in which the tax rules-of-the-game are susceptible to change from year to year. Both business and individuals need reasonably stable guideposts to steer by.

Fifth, a good tax system should be generally as neutral as possible in its effects on economic decision-making. This is crucial in an economy such as ours which is governed primarily according to the individual decisions of millions of separate consumers and producers, operating in a competitive market. The tax system should be so devised as to allow maximum play of the market in allocating resources. When business and economic decisions are based on narrow tax calculations, the effective functioning of the market system is impaired.

An additional objective of tax policy is that it ought to support the *general* fiscal requirements of the government. By this I do not mean to suggest that the tax structure should be constantly revised or juggled to accomplish specific short-term aims; this would do obvious violence to several other objectives I have already mentioned. But it is important that the tax system generally promote long-range continuing goals such as economic growth, or at least deter growth as little as possible.

When one sets forth these objectives of a "good" tax system, the shortcomings of the existing system become painfully clear. Yet how difficult it seems to be to make a beginning toward meaningful tax reform.

We all know tax reform is needed—but where to begin is less easily decided.

This is no place to advance another detailed program of comprehensive tax reform. However, I would like to address a few words to what appears to be a principal issue in current tax legislative proposals. That issue is fundamental to the basic problem of improving economic growth through capital formation. The issue is how to unleash business investment so as to modernize generally the industrial plant of America. On this issue has crystallized some of the main immediate legislative debates.

Capital formation is the key to long-term growth. In the recent past, serious question has been raised about the adequacy of capital formation in the United States. Throughout the decade of the fifties, as compared with countries like Canada, France, West Germany and Japan, capital formation as a proportion of total output was lower in the United States—and so was the rate of economic growth. There is reason here for genuine concern about the sluggish volume of business expenditures for plant and equipment, though to conclude that incentives as such for such expenditures are needed is to concede the failure of the profit motive in our modern private enterprise economy.

Adding urgency to this task of modernizing our manufacturing plants is the newly-intensified challenge of world competition. The time is over when we could view our internal requirements in one light and then consider their international repercussions separately and on some lower plane of priority. Clearly the Cold War outcome rests heavily on long-term economic power, as well as exacting national security expenditures over the immediate future. But, Cold War aside, the realities of competition in today's world markets demand that we modernize those main aspects of public policy which affect economic growth. In such a re-examination, tax reform must come near the top of the agenda.

Without cataloging the entire range of features which might play a part in a comprehensive reform package, I should like to comment briefly on investment: rate revision, depreciation policy, and the proposed investment credit plan.

Rate reduction is the fundamental problem in tax reform. I believe there is nearly universal agreement on this point; differences arise only on questions of timing and especially on whether the high rates should be attacked separately or in combination with other revisions designed to broaden the tax base.

The high and continuing necessary Federal spending commitments, many of them dictated by the international politics of our Age, make a continuing flow of Federal revenues absolutely indispensable. To argue that we should lighten the tax load on any one regardless of revenue effects would be irresponsible at the least.

The fact is, however, that the present steepness of personal income tax rates—up to 91 per cent, and reaching 50 per cent as low as $16,000 of taxable income—has very little merit in a revenue-raising way. Such rates *discourage* more economic activity than they *confiscate*. I believe that it has been convincingly argued, that properly directed, reduction of the steep progression in middle and upper brackets could bring about an increase in capital formation, thus enlarging the economy and providing a larger tax base so that any short-run revenue loss would be promptly made up.

Another implication of the problem of high tax rates is that every needless public expenditure should be eliminated. As of now approximately 20 per cent of our gross national product is required to keep the Federal Government running. Since we must continue to meet every demand which the Cold War imposes, all other types of expenditure must be scrutinized rigorously to meet the highest standards of the public interest.

The rate problem also points up another aspect of tax policy which has come in for some attention in discussion of current tax legislation: tax treatment of income from foreign sources. With the dominant corporate tax rate at 52 per cent, the proposed taxation of income earned in other countries has raised grave concern in some quarters. If tax policy is to support national objectives, we need to question carefully the effects of such a proposal on the economic expansion of a world which looks to American investment funds as a major source of financing growth. We need to question the effects on our ability to help customer countries build up with American know-how. We need to question the effects on our country's effort to stimulate exports of capital goods and components. Bearing in mind our national objective of energizing the growth and vigor of the Free World, the proposed taxation of income from foreign sources deserves very searching analysis.

Depreciation policy is certainly another key to investment and growth, along with rate reduction.

This audience is generally familiar, I am sure, with the outmoded character of present depreciation provisions, and its pronounced tendency to produce unrealistically long estimated lives. The basic problem is that the present provisions, developed during the Thirties and not basically changed since then, gear a company's recovery of capital to a superficial and obsolete measure of physical life of equipment. In the conditions of postwar competition, and accelerating technology, however, physical life has become vastly less relevant than economic or technological life.

The result has been, as one writer aptly phrased it, that: "Depreciation should be sued for non-support; it does *not* provide funds or any other assets for the replacement of property."

It has been estimated that, under present schedules, costs of replacement are outrunning depreciation allowances by $5 to $8 billion a year. Those who like to speak of "gaps" might well look into this capital replacement gap. It has far-reaching significance. The inadequate rate of capital formation in the Fifties is related to this gap, among other influences.

Industry has a responsibility to cooperate to the maximum with government by suggesting alternate solutions to depreciation problems. Without going into details at this point, it might be generally indicated that a good approach would allow industry to determine its own depreciation with the requirements that (1) each company has a theory-of-the-case supporting its depreciation, (2) it follows this theory consistently, and (3) it uses the same depreciation for tax purposes as it does for worth determination for share owners.

The need for modernizing depreciation policy poses a challenge to the accounting profession, one which has not adequately been met heretofore. This whole subject is simply not understood by the average taxpayer; certainly its importance to economic growth is not grasped. Accountants, who do understand what is involved, have a responsibility to contribute where they can to greater public understanding and support for needed changes.

An additional suggestion for stimulating investment has been advanced in the form of investment tax credit proposal.

The objective which the proposed investment credit is said to serve is precisely right. Like some of these other suggestions I have mentioned, it is directed at meeting the important need for correcting the climate for capital formation and modernization.

This growing recognition by so many, of the key importance of this common objective, has been welcomed by the business community. Perhaps it is an encouraging sign of greater economic and political sophistication that agreement can be reached that at the top of the list among tax proposals come measures to encourage plant expansion and modernization.

With respect to the specifics of the investment credit plan, however, I do not think it can go unnoticed that most business executives have shown a distinct lack of enthusiasm. Since there is agreement on the objective, the reasons for the disagreement on this specific plan should be spelled out. Let me summarize those reasons.

First, the basic objective is to remove deterrents to investment, and if the basic problem lies with unrealistic depreciation schedules, then why not deal directly with that problem? Why turn instead to a new device entirely? One main defect of the tax structure as a whole is that it is overloaded with special features and dispensations as it is. Let us not add another, especially when the problem it treats can be more directly attacked through depreciation reform.

Second, many believe that the investment credit plan seeks to stimulate certain kinds of investment—not necessarily the kinds which would be most productive or economic. Again the advantage of depreciation changes is clear, since these would essentially remove deterrents to effective management decisions on investment and let the market operate to channel available funds, as contrasted with governmental efforts to stimulate particular kinds of investment.

A third objection to the investment credit plan is that it could be changed from year to year and thus would introduce a substantial element of uncertainty in investment decisions. The original proposal plainly stated: "It may prove desirable for the Congress to modify the credit from time to time, so as to adapt it to the needs of a changing economy."

This flexibility feature of the investment credit plan raises the point which really concerns industry. Is it possible that, once this plan was adopted, it might later be jerked up and down in accordance with some debatable view of the economy's "needs?" Would it come to be modified industry by industry, or region by region, so as to stimulate those which seemed to need help? These considerations cause apprehension among many with whom I have discussed this plan.

How to create a long-term climate for expansion through the removal of deterrents to business investment—whether through fundamental depreciation reform or through the investment credit plan or, ultimately, through overhaul of the rate structure—is the most important question behind current legislative deliberations on tax matters. It is clear that at least this debate is on the right subject, because we are talking about the fundamental goal of improving the productive capacity of the economy.

With heavy national security expenditures facing us indefinitely in the period ahead, the total tax load will inevitably continue to be heavy. Whether this load will constitute a continuing drain on the vitality and growth of the economy, however, depends on what kind of tax system raises the needed revenue.

The challenge which this kind of a future poses calls for an important mutual understanding between the business community and the government. Business must recognize the revenue demands which the Cold War of necessity imposes on government. Government must recognize that *how* the revenue is raised and how well its expenditures are controlled will have a significant impact on the very sources of economic growth and tax resources and expenditure control with which public policy must be vitally concerned.

Antagonism between business and government cannot but defeat the objectives of both. One illustration of the significance of this point is in the field we have been discussing tonight, tax reform.

The effort to achieve meaningful tax reform has been a long-continuing one. Dramatic results overnight are highly unlikely. But the goal is important enough—and the cost of mistakes is high enough—to require our close attention and support.

In these efforts, a general guideline which is well worth remembering is Alfred North Whitehead's description of progress: "The art of progress is to preserve order amid change, and to preserve change amid order."

FIFTH SESSION

FRIDAY, MAY 18, 10:00 A.M.
Ohio Union—Conference Theater

Presiding:

RAYMOND C. DEIN, PH.D., *President, American Accounting Association; Professor of Accounting, The University of Nebraska, Lincoln, Nebraska*

Paper: "The C.P.A. and Ethics of Tax Practice"

PAUL F. JOHNSON, C.P.A., *Partner, Ernst & Ernst, Chicago, Illinois*

Paper: "Charting the Tax Perils in the Area of Form Against Substance"

ABRAHAM S. GUTERMAN, *Partner, Hess Mela Segal Popkin & Guterman, New York, New York*

Paper: "Undervaluation of Inventories"

RAYMOND E. GRAICHEN, C.P.A., *Partner, Lybrand, Ross. Bros. & Montgomery, Philadelphia, Pennsylvania*

THE C.P.A. AND ETHICS OF TAX PRACTICE

PAUL F. JOHNSON, C.P.A.
Partner, Ernst & Ernst
Chicago, Illinois

We are often reminded that the foundation of our national fiscal system is the self-assessment method of taxation and that we must never allow that system to falter. It has been estimated that 97 per cent of the tax receipts of our Federal Government are collected through the self-assessment method and our tax collecting authorities feel that one of the most important duties imposed upon them is to insure that the wholesome respect accorded our federal tax laws by our citizens is maintained.

It is quite evident that for the past several years the watchwords of the Internal Revenue Service have been "enforcement" and "compliance" and the campaign has continued with increasing intensity down to the present time. If evidence is needed that the campaign of enforcement and compliance has been and continues to be a prime objective of our government a few examples of activities in this area should establish the point.

In the first place, we have the continuing pressure on travel and entertainment expenses starting with the famous line 6(a) in the 1957 personal income tax return blank and continuing with the revision of regulations, questions on tax return forms relative to so-called luxury facilities and amounts of "expense account allowances" to officers, partners and owners, increased intensity of investigation of such expenses by Revenue Agents and finally the report on the investigation of these expenses conducted by the Service late in 1961. It appears that this particular effort will culminate in provisions in the Revenue Bill of 1962 which will prohibit deduction for most entertainment expenses, eliminate the long-standing Cohan rule relating to the estimation of expenses in the absence of definite amounts and disallow a substantial part of the cost of maintenance of entertainment facilities. For purposes of this particular section, club dues are regarded as an entertainment facility.

Another example in the campaign of enforcement and compliance is the attention being paid to inventory valuations. The President stated in a message to the Congress in April, 1961 that this was a source of concern and one to which Revenue Agents had been directed to give increased attention. This particular effort has resulted in the inclusion of several questions regarding inventory valuations in the 1961 business tax return forms, including one calling for disclosure of the cost and inventory value of those items that have been written down from cost to market.

Another item in the compliance area is the Code provision which became effective for the first time for the calendar year 1961 that requires reporting of information regarding transactions with foreign subsidiaries and affiliates. A companion move in the compliance campaign with regard to this type of transaction is the organization of the International Operations Office within the Service. The purpose of this Unit is to investigate foreign transactions and to advise Revenue Agents as to their proper handling.

Another activity with overtones of compliance is the Automatic Data Processing program of the Service, and the related use of taxpayers numbers in order to associate taxpayers' returns with reports by payors of interest, dividends, etc. On this subject, *Time* magazine in its issue of April 13, 1962, had an interesting comment, stating:

> "The I.R.S. has in the works a system calculated to scare the daylights out of every taxpayer in the land. It is called ADP—for automatic data processing—and its heart will be an electronic computer system headquartered at the National Computer Center at Martinsburg, West Virginia."

The Revenue Bill of 1962 has several provisions in the compliance area in addition to those relating to the deductibility of travel and entertainment expenses. These include provisions for the purpose of requiring more prompt reporting of income earned by foreign affiliates for U.S. income tax purposes, a provision to tax gain on the sale of depreciable personal property as ordinary income to the extent of depreciation previously taken, and a provision that would require the withholding of tax by the payors of interest and dividends.

Finally, there is the increasing work force of the Internal Revenue Service which is now approaching the 60,000 level and Congress has been asked to increase the appropriation for the Service so that more personnel can be hired to examine a greater percentage of the returns filed.

While we continue to refer to our collection of federal revenues as a self-assessment tax system, it appears that more and more pressure is being applied to make certain that the system continues to function. It may be that the self-assessment system works efficiently because the great majority of the people fear the consequences of any other course. As Thomas J. Graves, a C.P.A. of New York stated in the January, 1962 *Journal of Accountancy*:

> "There is evidence that self-assessment is becoming less and less a true characterization of our system. Enforcement is taking an increasingly important role . . . ."

Recognizing that we are in an era in which compliance by taxpayers is a prime consideration of our taxing authorities, it is not surprising that tax practitioners and return preparers have become involved in this effort. Considerable attention has been accorded by them to the "ethics" of their practice and what constitutes "good conduct" in tax practice. For the past three years this matter has been under consideration by the newly created Committee on Ethics of Tax Practice of the American Institute of Certified Public Accountants. In the past year or two articles have appeared in professional journals on such subjects as ethical conduct in tax practice and the responsibilities of return preparers. The programs of meetings, conventions and conferences of professional groups often include talks and panel discussions on these and similar subjects. This subject has also received the attention of the Internal Revenue Service. In a speech given in Chicago last October entitled, "The Travel and Entertainment Expense Problem," Commissioner Caplin touched upon the responsibility of the return preparer and said, ". . . . But aside from any question of culpability or technical wrong, issues of this sort frequently turn upon 'good tax practice'—what does the decent, responsibile practitioner do under these circumstances?" On January 31, 1962, I.R.S. News Release No. I.R. 444 was issued relative to the examination for special enrollment to practice before the Internal Revenue Service. The release stated:

> ". . . . The Director of Practice indicated that the 1962 examination will be similar in content to those held in prior years. However, the examination will contain additional material designed to test the candidate's knowledge concerning the ethical responsibility of an enrolled person."

In February of this year (and no doubt of considerable significance), Mr. Caplin announced in a speech before a C.P.A. group in Texas that the Service was studying the possibility that the examination of returns might be reduced or eliminated in cases where the preparer would assume greater responsibility for the return.

Despite the fact that the ethical conduct of tax practitioners has been under active discussion for the past two or three years, it does not appear that the C.P.A.s have made any particular progress toward the promulgation of rules of conduct for tax practice. The situation is practically the same as it was in 1960 when, speaking before this Institute, Albert H. Cohen, a New York C.P.A., stated:

> "The net result is that at the present time there is no unified statement of principles or standards to guide C.P.A.s in their own conduct of tax practice or on which individual practioners may rely when their own actions may be questioned."

Despite the thought and attention that has been given this problem since the foregoing statement was made two years ago, it is doubtful that agreement could now be reached among C.P.A.s, who are only one of the several groups of tax return preparers, on any "unified statement of principles or standards." Many C.P.A.s would vigorously argue that the rules of professional conduct of the national and state professional organizations cover all phases of a C.P.A.'s practice including tax work and that it is not desirable or practical to have one code of ethics for the audit of financial statements, another for tax work, and a third for management services.

Certainly, the absence of a statement of principles such as mentioned by Mr. Cohen does not mean that the C.P.A. is without inhibitions or restraints in tax practice. He is subject to the rules of conduct of his professional organizations in all of his work. He signs the tax return jurat stating that under the penalties of perjury, to the best of his knowledge and belief the return is true, correct and complete. Section 7206, I.R.C. provides that anyone who aids or assists in the preparation of a fraudulent return shall be guilty of a felony and subject to fine, imprisonment or both. Last, but not least, the C.P.A.'s own professional reputation is at stake and he well knows that involvement in a fraud case may hurt him. When a taxpayer is charged with fraud, his counsel must seek out all possible defenses and if it can be shown that the alleged acts of fraud were known to the C.P.A. it would no doubt be of great help to the taxpayer but could be very harmful to the C.P.A. Many C.P.A.s are very well aware that no tax fee can adequately compensate them for involvement in a fraud case.

C.P.A.s have been rendering tax services and preparing returns for many years without a code of conduct designed specifically for tax practice. Many practitioners are not convinced that such a code is desirable or necessary.

There is little doubt but that there is a great deal of misunderstanding in the mind of the general public as to the responsibility assumed by the C.P.A. when he prepares a tax return. With the general reputation of

C.P.A.s for accuracy and extreme care in their work, it is very difficult for many people to understand that when a C.P.A. signs a tax return, he is not underwriting the correctness of every figure in it. As John L. Carey, Executive Director of the A.I.C.P.A., has said in his "Professional Ethics of Certified Public Accountants" (page 45):

> "It has been well said that the C.P.A. certificate has acquired such general prestige, and is so closely associated in the public mind with independence and integrity, that any statements with which a C.P.A.'s name is associated, gain added creditability thereby, even though he has made no audit or has not expressed a professional opinion on the financial statements . . . ."

There is evidence that this misunderstanding of the responsibility of a C.P.A. when he signs a tax return extends to some fairly high places. Again referring to Albert H. Cohen's paper before this Institute in 1960, he cites remarks of the then Senator Kennedy indicating his belief that, when a C.P.A. signed the jurat on a tax return, he certified the reasonableness and accuracy of the information contained in the return. Other Government officials have been known to take the position that, when a C.P.A. signed a tax return, he was presumed to have informed knowledge with respect to each item entering into the return. This lack of understanding of the meaning of a C.P.A.'s signature on a tax return has been a cause of concern within the profession and was one of the reasons for the formation of the A.I.C.P.A. Committee on Ethics of Tax Practice.

Just what is the responsibility of the C.P.A. in signing a tax return? The current jurat says:

> "I declare under the penalties of perjury that I have examined this return (including accompanying schedules and statements) and to the best of my knowledge and belief it is true, correct, and complete. If prepared by a person other than taxpayers, his declaration is based on all information of which he has any knowledge."

By the terms of the jurat, the liability of the return preparer is limited to those things of which he has knowledge. Obviously the amount of knowledge that the C.P.A. will have concerning particular returns will vary, depending primarily upon the terms of his engagement.

First, consider business tax returns. If the engagement of the C.P.A. is to make an examination of the financial statements and in that connection he is to prepare the tax return, he will obviously know a great deal about the affairs of his client and in such a case his knowledge would give him substantial responsibility for the return.

The client may not want or need the C.P.A.'s opinion on his financial statements, yet he wants assurance that the records are adequately maintained and reasonably reflect the financial condition of the business and will result in an accurate tax return. In such a situation the C.P.A. might make a general review of the accounts and prepare financial statements and the tax return. In this circumstance his responsibility would be less than in the case where he examined the financial statements since he did less work and consequently has less knowledge.

Finally, the client may engage the C.P.A. to merely take the figures from the books and prepare a tax return. There are, of course, many variations in the procedures followed by C.P.A.s when no opinion on the financial statements is issued. The three examples outlined above include one situation with substantial knowledge, one with minimum knowledge and one between the two extremes. In all three of these situations, the C.P.A. would probably sign the same jurat. Rather extensive checking with C.P.A.s reveals that only in rare situations do they qualify the printed jurat. The almost universal opinion appears to be that the "knowledge" exception in the jurat covers the great majority of situations.

The question might very logically be asked if it would not be helpful to the Service to know how much work the C.P.A. had done and thus have some idea of the extent of his responsibility. Several years ago the A.I.C.P.A. proposed a jurat that would so indicate, but it was never adopted because of the opposition of other practitioners who did not make audits and felt such a jurat would discriminate against them.

It is generally recognized that the preparation of business tax returns by C.P.A.s in cases where audits of the financial statements are not made is certainly an appropriate and legitimate service for the C.P.A. to render. In fact, in the case of a great many smaller C.P.A. firms and individual practitioners, the bulk of their practice consists of the preparation of financial statements without audit and tax returns. It would be unreasonable to deny the tax services of the C.P.A. to those businesses which did not want, could not afford, or did not need audited financial statements.

In addition to the preparation of business tax returns, C.P.A.s generally prepare a great many personal tax returns. It is the rare exception when individuals maintain what might be called a set of books and in most instances the starting point in the preparation of a personal tax return is memoranda furnished to the C.P.A. by the taxpayer which he has prepared primarily from his check books. Only in unusual cases does the C.P.A. insist upon checking into the check books or other source material himself.

By the terms of the jurat the responsibility of the C.P.A. in tax return preparation is limited to those matters of which he has knowledge. He cannot avoid responsibility for those things he knows about, and this fact should be ever before the return preparer when he might be tempted to disregard information he has in hand.

While it is well established that a C.P.A. must take cognizance of all matters that he knows about in the preparation of tax returns, there is no authoritative source of information regarding his obligation to seek knowledge regarding the affairs of his clients. It is quite probable that the lack of agreement in this regard is one of the principal reasons for the frequency with which the topic is discussed. As in much of his work, the extent to which a C.P.A. seeks tax return information is a matter of judgment and professional responsibility. He cannot justify ignoring the obvious or failing to challenge items which his training and experience should suggest to him are questionable. Admittedly, these statements are generalities and are subject to individual interpretations. Some of the more specific questions that have been raised in various discussions, usually without answers, are the extent to which interest and dividend income in the return under preparation should be compared with the amounts reported for the prior year and explanation of differences secured; to what extent should the treatment accorded agreed items in Revenue Agent's reports be followed in later years; and should estimated deductions in a tax return be clearly indicated as such. It would appear that if any statement of the responsibility of C.P.A.s in tax return preparation undertakes to answer specific questions such as those outlined above, it will come about through a long period of evolution and during the process will give rise to considerable debate among practitioners.

The question has been raised a number of times as to whether or not a C.P.A. has or should assume a higher standard of responsibility in tax practice than other practitioners. Some prominent members of our profession feel that the public expects higher standards of responsibility from C.P.A.s than is expected from others in tax practice, and that we should recognize this fact and act accordingly. Two questions might be raised with respect to this position, namely, who are the "others" in tax practice to whom reference is made, and how can we say that we should have higher standards of responsibility than others, when there is a lack of agreement as to what our own specific responsibilities are or should be, let alone what the standards of responsibility of others should be.

With respect to the "others" in tax practice, we start with the obvious fact that the C.P.A. has no monopoly on this particular service. There are a host of others rendering tax services covering the entire gamut from the senior partner of the large law firm in the big city that specializes in tax practice to the bookkeeper who prepares returns for a nominal fee during evenings of the filing season in the corner currency exchange or real estate office. As a matter of fact, the Internal Revenue Service appears to have encouraged the non-professional in tax practice by two actions within the past few years. First, the Service now permits preparers of returns, except for corporations, to represent that taxpayer in the informal conference. Secondly, the Service now permits non-professionals to qualify by examination for the so-called "Treasury Card" which allows them to represent taxpayers at administrative levels, the same as the lawyer and C.P.A.

What then are the standards of responsibility of the C.P.A. in relation to the host of other practitioners including persons with widely varying amounts of education and experience? Must the C.P.A. adhere to higher standards of responsibility than all of these just because he is a C.P.A.? It seems unreasonable to say that a lawyer could properly do certain things in tax practice that are inconsistent with the standards of responsibility of C.P.A.s. Our friends who are attorneys would no doubt vigorously deny that they have any lesser degree of responsibility in tax matters than the C.P.A. Standards of responsibility in tax return preparation are related by the jurat to the knowledge of the practitioner. It is reasonable to assume that the C.P.A. has greater technical knowledge with respect to tax matters than the average non-professional, and the greater the knowledge the greater the responsibility.

There should be only one standard of responsibility with respect to tax practice. Differences in responsibility can only be justified by differences in knowledge. An inexperienced return preparer could be excused for certain practices on the ground that he does not know any better, whereas the C.P.A., knowing they were wrong, could be guilty of bad faith.

There is certainly no intent to deny that C.P.A.s must have a high degree of responsibility in tax practice. However, John P. Weitzel, Deputy to the Secretary of the Treasury stated in a speech before the 1959 A.I.C.P.A. annual meeting (February, 1960, *Journal of Accountancy*) that the "due diligence" provision of Circular 230 was never intended to place any greater burden on C.P.A.s than other enrollees. We should, by our conduct in tax practice, merit the respect of our clients, the Service and other practitioners. This respect must be earned through our professional conduct and technical skills.

From time to time people ask what is, or what should be, the posture of the C.P.A. in tax practice. Should he consider himself as a representative of the Internal Revenue Service, should he try to perform like a judge and impartially decide what he believes to be the "right" course to follow, or should he do his best to represent his client, to be an advocate of the client's position so long as he is convinced that the position that would best serve the client's interest has merit.

There is no reason whatsoever why the C.P.A. cannot be an advocate of the client in the rendering of tax services, granting that this places the C.P.A. in a different position than he is in when issuing his opinion on financial statements. As stated in an editorial in the June, 1960, *Journal of Accountancy*, "When a C.P.A. prepares an income tax return, his function is obviously very different from expressing an opinion on financial statements."

In John L. Carey's book *Professional Ethics of Certified Public Accountants* (page 24), Dean Griswold of Harvard Law School is quoted as saying:

"The accountant has many functions. One of them is to set up systems of accounts. Another is to carry out audits. In the latter capacity, the accountant is referred to as the 'independent accountant.' He puts his certificate on the company's balance sheets and published reports; investors and bankers, the S.E.C. and the stock exchange, and others, rely heavily on the accountant's independent judgment. In performing this function, the accountant acts in a very real sense judically. He must decide questions, and he must be wholly free to decide questions against his client's interest if his investigation and judgment lead him to that conclusion."

"My question is this, and it bothers me: Can this independent quasi-judicial function be properly performed by a person who also undertakes to act as an advocate for the client? . . . The accountants have an important function in being independent examiners, and they have a long and honorable history in that work. Is this function really consistent with their acting as advocates for their clients before the Treasury? . . . ."

Maurice H. Stans, the then President of the American Institute of Certified Public Accountants, replied to Dean Griswold and said in part:

"There does not seem to be any real difficulty here. The fact that a C.P.A. presents independent findings to his client or to third parties on financial matters doesn't require him to remain aloof on other proper ways of serving his client, so long as he does nothing to prejudice his independence of views on the financial statements . . . . . A lawyer who gives an opinion as to the validity of a proposed issue of securities for inclusion in a prospectus is functioning no less as an independent expert than the certified public accountant who gives an opinion on the financial statement included in the same prospectus. Like the lawyer, the certified public accountant can properly perform other functions in addition to giving independent opinions. . . . ."

There can be no question but that C.P.A.s have acted as an advocate for their clients in tax matters, that they are so acting at the present time, and that they will continue to act as the client's advocate in the future. This activity is properly within the scope of the tax services rendered by the C.P.A. In our self-assessment method of taxation, individuals (as well as corporations and others) are in the unique position of being assessors of taxes and payors of taxes at one and the same time. These positions are naturally in conflict with one another, yet we accept the proposition that taxpayers have the right to resolve legitimate doubts in their own favor. As the representative of the taxpayer, preparers of tax returns should act for the taxpayer in the same manner that the taxpayer, being fully informed, may legitimately act for himself. There are many areas in the tax field that are not black or white and in attempting to resolve doubtful questions, the C.P.A. should not try to substitute his judgment for that of the courts after litigation of the issue. For example, should the C.P.A. contend that any voluntary payment to a widow by her deceased husband's employer constitutes taxable income to her in view of the fact that court decisions on the issue are in disagreement? It would appear appropriate to exclude such receipts from taxable income until the issue is resolved. Taxpayers are entitled to return preparation and representation in tax matters by persons who act as their advocates. C.P.A.s should carefully guard their rights to so act for their clients.

On February 15, 1962, in a speech before a group of Texas C.P.A.s, the Commissioner of Internal Revenue made some comments regarding tax return preparation that were of great significance and have received widespread publicity. Mr. Caplin stated that the question of whether C.P.A.s and other return preparers should assume more responsibility in the filing of returns was under study by the Service. He stated that this consideration was a part of the effort of the Service to do everything possible to strengthen voluntary compliance. He added that this would involve full or partial acceptance without examination of returns prepared by persons "approved to perform such services."

It is apparently contemplated that ethical standards of practice would have to be adopted prior to the start of the program, since the Commissioner said ". . . . ethical standards with respect to tax return preparation would have to be carefully formulated to minimize any possible misunderstanding in the minds of tax practitioners." In a later paragraph in which ethical standards were mentioned, he said, "When these standards are formalized and adopted by leading groups of tax practitioners, the Service will be in a better position to determine the degree of reliance it should place on returns prepared by approved tax practitioners."

By "leading groups of tax practitioners," it is assumed that he means lawyers and C.P.A.s, and apparently they will have to agree upon specific ethical standards. This seems to be a very large order. Anyone familiar with the procedures for amendment of the A.I.C.P.A. Rules of Professional Conduct is well aware that a single addition takes many months, if not years, to become effective. The legal profession no doubt has similar procedures, yet what organization of lawyers would adopt these standards? There are Bar Associations of lawyers in cities, counties, several counties, the various states and the United States.

There is the question of the agreement to standards by the multitude of return preparers who are outside the ranks of the practicing lawyers and C.P.A.s such as the non-certified public accountant, banks whose employees prepare returns for customers, and the many individuals who usually on a part-time basis prepare smaller returns during the filing season in some business establishment such as a currency exchange. Assuming that ethical standards are adopted by the lawyers and C.P.A.s, could these unorganized return preparers voluntarily adopt or on the other hand be made to comply with such standards?

In his February 15 speech, the Commissioner remarked that it was estimated that $500 million of additional taxes were collected through examinations of large corporate returns filed for the year 1956, and that all of these returns had been prepared by C.P.A.s. It is hoped that the Commissioner did not mean to infer that these deficiencies were the result of the failure of C.P.A.s to observe appropriate standards. In the very complicated and often confused state of our tax laws, it is not surprising to learn that this amount of deficiencies resulted from the examination of large corporate returns. It may well be that a very substantial part related to legitimate differences of opinion that resulted in litigation. It would be interesting to know how the final $500 million of deficiencies compared with the aggregate of the deficiencies initially proposed by the Service; also what portion represented true deficiencies as contrasted with those resulting from the shifting of income and deducations between years.

The Commissioner stated in his speech that certain procedures were under consideration in connection with the contemplated program.

The first of these procedures was a certification, either blanket or limited, as a part of the jurat on the return to be signed by the return preparer. Under the present jurat, the return preparer assumes responsibility for anything of which he has knowledge. It would appear, therefore, that, if the preparer is to assume more responsibility, he would have to gain more knowledge and that he would secure this knowledge by extensions of his audit procedures. It is generally recognized that the standards of materiality followed by C.P.A.s in expressing an opinion on financial statements are not necessarily applicable to tax returns. An item may be considered as immaterial in its effect upon the financial statements taken as a whole yet could be the source of a protracted dispute upon examination of the tax return. The C.P.A. apparently would be required to do more auditing to "certify" the tax return than he would to issue his opinion on the financial statements. This situation raises a number of questions. How will the client react to increased audit fees caused by the additional time required to "certify" the tax return? Can the C.P.A. prepare the tax return as he has in the past without the added certification? How about the return of the taxpayer who does not have an audit of his financial statements? Can he still avail himself of the services of the C.P.A. to prepare his tax return?

The second procedure mentioned by the Commissioner, and I quote him, was, "2. Submission of supporting schedules covering significant items determined by the Service. These schedules would accompany all certified returns." This statement could lead to a great deal of conjecture but there appears to be no question but that more information would be required to be filed with a "certified" return than would be the case if the taxpayer prepared the return himself. To indulge in a bit of conjecture, it might be possible that additional information would be required on travel and entertainment expenses, repair and maintenance costs, basis of intercompany pricing of sales between related taxpayers, particularly foreign, and there could be questions designed to disclose what the preparer believes to be the debatable issues in the return.

The third and last procedure set forth by the Commissioner was that a copy of the C.P.A.'s audit report would be required to be attached to the income tax return. This should raise no particular questions or objections from either the C.P.A. or the taxpayer.

In the course of his comments, the Commissioner mentioned "returns prepared by persons approved to perform such services," "returns prepared by approved tax practitioners" and "C.P.A.s and other approved return preparers." It would appear, therefore, that the Service would issue some evidence of "approved return preparer" to those persons who were found to have the necessary qualifications to certify returns. The Commissioner wisely noted that adequate control measures would be required to insure adherence to established standards. It would seem likely that the Service would make examinations of "certified" returns on a test basis to insure adherence to established standards and that those individuals who were found to be failing in their duty to observe such standards would have their right to certify returns revoked.

In summary then, it would appear that, if a taxpayer were to file a certified return, he would probably be required to authorize a more comprehensive audit of his accounts by the return preparer, at least in certain areas, and would be required to furnish more information relating to items specified by the Service than if he prepared the return himself. In return, the likelihood of his return being subjected to examination would be substantially reduced.

With all of the discussion about ethical standards in tax practice, the position of some that C.P.A.s should have higher standards of responsibility than other practitioners, and the study by the Service of the possible assumption of added responsibility in the filing of tax returns, the C.P.A. might well question whether or not these are inferences that he has not been living up to his responsibilities in tax work. However, we may take heart from a paragraph included in the Commissioner's February 15, 1962, speech in which he said:

"Your assistance and co-operation in many fields has long been a source of strength to the Internal Revenue Service. We lean heavily on the accounting profession to help us maintain a high level of voluntary compliance in our self-assessment tax system."

There is general agreement that our federal tax laws are highly complicated and that the public needs expert help in fulfilling its tax obligations. The accounting profession is a most important group in the rendering of competent tax help which must be of great assistance to the Internal Revenue Service. There is no way to measure the impact of the C.P.A. on our self-assessment method of collecting taxes, but without question the accounting profession exerts great influence upon taxpayers in their compliance with our taxing statutes. We are proud of our record in tax practice.

CHARTING THE TAX PERILS IN THE AREA OF FORM AGAINST SUBSTANCE

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Although judicial pronouncements abound that a taxpayer has the right to organize his transactions and set them up in a fashion whereby he pays the least tax and that where several alternative forms are available to effectuate a transaction, the taxpayer may choose the one least costly taxwise, nevertheless, any transaction which has the obvious purpose of reducing or avoiding taxes may be challenged on the ground that the primary motive of tax saving entitles the Government to disregard the form of the transaction.

Because the Government's challenges have been tailored to the variety of transactions in which the tax motivations have been dominant and because transactions have sometimes been the product of the fertility and ingenuit y of taxpayer's counsel, it is difficult on the basis of the decided cases to formulate any precise principle to avoid or withstand such challenge.

Generally speaking, the struggle has consisted of the Government's taking an extreme position in the realm of interpretation to bring a transaction under the cover of an inadequately worded statutory provision or to challenge the transaction itself as unworthy of recognition even though it is clothed with ostensibly proper legal forms. On the other hand, the taxpayers have attempted to capitalize on apparent limitations of statutory coverage or the effort to squeeze the form of transactions within literal statutory language.

It may be superfluous to state that in the first instance any careful tax practitioner would attempt to set up transactions which have normality, and which are not bizarre and far off the beaten track. In the auditing process, the absence of normality in the choice of the form of a transaction will generally invite the kind of scrutiny which may ultimately end up as a challenge on the question of form against substance.

There has been a substantial proliferation of judicial decisions in this field and in charting the tax perils some attempt must be made to distill a principle which can guide the tax practitioner. Such a principle which this paper will attempt to substantiate as reflecting the present state of the law might be phrased in this fashion:

Any form of transaction which is motivated exclusively by tax savings and cannot be supported by non-tax factors may be disregarded for tax purposes.

Non-tax factors which may negative an assertion of pure tax motivation may be listed as follows:

1. Presence of an opportunity for profit other than the profit from tax savings.
2. Presence of risk of loss which refers to possible risk of loss in excess of tax advantages gained, but does not refer to loss before taxes deliberately incurred to obtain an after-tax profit.
3. The economic reality of a transaction, sometimes stated as the requirement of "business purpose."
4. Normality of forms employed.

The nature of the transaction would determine when a particular factor enters into any determination. The elements of opportunity for profit and risk of loss are clearly relevant when dealing with a purchase and sale. On the other hand, the normality of forms employed and the economic reality of a transaction may be more appropriate in judging a transaction involving the use of corporations or trusts.

A confusing element in this area has been the indiscriminate use of the term "sham" as a general description of a transaction or series of transactions lacking the necessary substance to stand for tax purposes. If a transaction is clearly not what it purports to be it may be characterized as a sham transaction, but in dealing with transactions that are real and legal, tax status must be tested by the factors listed above which may outweigh the presence of tax motivation.

In recent years the form against substance controversy has been fought out in the area of the interest deduction. Starting with the *Goodstein* case, 30 TC 1178 (1958), aff'd 267 F(2d) 127 (1st Cir. 1959) which involved a tax saving plan aimed at securing an interest deduction based on the purchase of United States Treasury Notes in which the interest deduction was disallowed on the ground that it lacked substance, a whole series of cases were decided on the same basis. These cases rested not only on the absence of substance but also on the contention that an interest deduction required a business purpose or profit motive. See *Lynch*, 31 TC 990 (1959), aff'd 273 F (2d) 867 (2d Cir. 1959); *Julian*, 31 TC 998 (1959), aff'd sub nom. *Lynch*, 273 F.(2d) 867 (2d Cir.

1959); *Miles*, 31 TC 1001 (1959); *Broome*, 170 FSupp 613 (Ct Cl 1959). The Second Circuit in *Lynch* based its affirmance of the Tax Court on the ground that the whole elaborate series of steps "did not in fact produce the legal transactions which they simulated." The Court therefore rested not on any requirement of business purpose for an interest deduction, but, rather, that an interest deduction required the existence of a true indebtedness and that under the circumstances of the case there was not such an indebtedness.

The Tax Court in *Stanton*, 34 TC 1 (1960). (See also Clifford F. Hood, TC Memo 1961-231 filed 8/16/61) rejected the requirement of business or profit motive in connection with an interest deduction and dealt with the real problem which was whether a true indebtedness had been created. In that case, since the borrowing was from banks and the purchase and pledge of securities were clearly evidenced, the Court concluded that the interest was deductible and interpreted all of the cases of the *Goodstein* group as correctly decided on the basic ground that in all of them there was no true indebtedness.

A similar problem arose in the *Knetsch* case, 346 US 361 (1960) which was decided by the United States Supreme Court and which dealt with an interest deduction involving the borrowing of money from an insurance company on the security of annuity bonds and deducting the interest paid thereon. The Supreme Court held that the transaction was a sham, in that there was no true indebtedness on which the interest deduction could be claimed. This decision ended the uncertainty in this particular area resulting from related cases such as *Emmons*, (3rd Cir. 1959) and *Weller*, 31 TC 33 (1958), aff'd 270 F(2d) 294 (3rd Cir. 1959).

The new approach reflected by the *Stanton* case above was applied in a *Knetsch* type of situation in *Loughran*, 19 TCM 1193 (1960). In that case where the borrowing was from a bank in a regular collateralized loan rather than from the insurance company, the Court found a true indebtedness justifying an interest deduction. The line of cases represented by *Goodstein* and *Knetsch* which referred to the language of form against substance and used words such as "sham" and "simulation" are not too helpful in the attempt to distill a principle in this area. In these situations, a transaction was determined not to be what it purported to be. In the search for a principle, the problem is focused most precisely where transactions are real and valid but are entered into for tax reasons. It is in this area that we can explore the question of whether the existence of other factors such as risk of loss and opportunity for profit would be sufficient to overcome the tax motivation.

A clear example of the form against substance problem, directly focused, is *Maysteel Products*, 33 TC 1021 (1960) rev'd 287 F(2d) 429 (7th Cir. 1961). In that case, the taxpayer corporation bought $100,000 face value of bonds at a premium of approximately $15,000. The bonds purchased on September 22, 1953, were subject to a 30-day call for redemption at slightly over par. To make the purchase, the taxpayer borrowed $100,000 from a bank and paid the balance (the amount of the premium) from its own funds. It gave the bank its promissory note for $100,000 at 3¾ per cent interest, due 35 days after date, and deposited the bonds with the bank as collateral.

A month and a day later, on October 23, 1953, the taxpayer recorded on its books amortization of the full amount of the premium, and three days later donated the bonds, subject to the outstanding indebtedness, to a tax exempt corporation. The following day, the tax exempt corporation sold the bonds for approximately $119,000.

The taxpayer took deductions, as allowed by the Internal Revenue Code, for both amortization of the bond premium and a charitable contribution. The facts established that the entire transaction was proposed to the taxpayer by a broker soliciting business from its clients who might be interested in the cumulative tax benefits of both the amortization and the charitable deductions, and it was further found that ". . . the transaction, and each of the component steps, was designed to effect a charitable gift with the concurrent motive of generating an amortization deduction in addition to the charitable deduction."

The Court was squarely faced with the question whether the character of the transaction and the motivations that prompted it precluded the amortization deduction. The Commissioner relied for disallowance on the cases of *Knetsch, Gregory* v. *Helvering* and *Gilbert* v. *Commissioner*, 248 F(2d) 399 (2d Cir. 1957). The Court distinguished those cases finding that they involved either "sham" transactions or transactions lacking "economic reality." It found that in the case before it, the bond purchase, the loan and the note, etc., were genuine and that the taxpayer was exposed to all the usual business risks involved in such transactions. Therefore,

> "*The motivation involved does not destroy the commercial reality and genuineness of the transaction.*" (Emphasis ours) (287 F(2d) 429).

A similar case was *Evans* v. *Dudley*, 188 FSupp 9 (WD Pa, 1960), where the Court found the taxpayer's purchase was real and legitimate in the open market at arm's length with outstanding financial institutions resulting in an appreciable change in taxpayer's financial position, and that taxpayer, until its later disposition of the bonds, had all the incidents of ownership, including a substantial risk.

Where bonds were purchased in an arm's length transaction with funds borrowed from a bank, the premium in excess of the call price had been held deductible despite the fact that the bonds were purchased primarily to obtain this deduction and sold shortly thereafter. *Estate of Gourielli* v. *Comm'r* and *Goldfarb* v. *Comm'r*, 289 F(2d) 69 (2d Cir. 1961); *Parnell* v. *U.S.*, 187 FSupp 576 (1958) aff'd without opinion 272 F(2d) 943 (6th Cir. 1959). In these cases, the only real issue was whether the regular or a special call price should be used in computing the deduction.

In *Doyle* v. *Commissioner*, 286 F(2d) 654 (7th Cir. 1961), the taxpayer bought, in January and February of 1953, shares of stock in three corporations. On November 27, 1953, he bought identical amounts of the same stocks long, on margin, and deposited with his broker, as collateral, the shares originally bought in January and February. On the date of the margin purchases, taxpayer sold the identical stock in identical amounts short for the same prices. On December 30, 1953, he instructed his broker to cover the short sales with the stock deposited as collateral for the margin purchases. The broker cleared the short account, depositing the money received to balance the margin account. The net result was that the taxpayer retained certificates representing his margin purchases of November 27th.

It was found as a fact that the taxpayer had made both the long margin purchases and short sales with the intention of maintaining his investment position in the stock and that the entire transaction was entered into merely for the purpose of establishing his loss. The Commissioner contended that the simultaneous short sale and long purchase were without economic reality or substance, and hence did not fall within the broad requirement of Section 23 (1939 Code) that the transaction be entered into for profit.

The Court stated that it was an everyday occurrence to time a loss to match gains and that the profit element was sufficiently present if the sale was made to establish a capital loss, since "such sales are entered into for 'profit' to the degree that they ultimately minimize tax liability." The Court went on to say that the cases cited by the Commissioner involved chicanery to create a loss deduction which was not present in this case, and that this loss was therefore properly deductible.

A very strong holding for the taxpayer on this general subject is the decision of the First Circuit, reversing the decisions in the *Fabreeka Products Co.*, 34 TC 290 (1960), rev'd 61-2 USTC ¶9678 (7th Cir. 1961), *Sherman*, 34 TC 303 (1960), rev'd 61-2 USTC ¶9678 (7th Cir. 1961) and *Friedman* 34 TC 456 (1960), rev'd 61-2 USTC ¶9678 (7th Cir. 1961) cases. In *Fabreeka* the taxpayer, in the manufacturing business, had six stockholders. It obtained a loan from a bank and with this money and some of its own purchased public utility bonds which were callable on 30 days' notice at a substantial premium above the call. The loan covered the callable amount and the bonds were pledged to secure it. The bonds were held for 30 days, *Fabreeka* wrote off the premium down to the call price as a deduction, and distributed the bonds subject to loan to its stockholders as a dividend. The stockholders promptly sold them at the same premium which they retained after paying off the loan. Various facts indicated that the transaction was entered into to accomplish the tax savings.

In the *Sherman* case, an individual taxpayer purchased similar bonds at a premium, wrote off the premium in 30 days, sold the bonds after six months and reported the recovered premium as a long-term capital gain. Here again the Tax Court found that the anticipated tax saving was the sole motive for the transaction.

In *Friedman*, the taxpayer gave the bonds to a charity instead of selling them, subject to the lien of a purchase loan, and the taxpayer claimed the amortization and charitable deductions.

The First Circuit examined the facts in these cases and the Government's contention that the transactions had no reality. The Court found that these were not sham transactions, that they involved risks beyond the control of the taxpayer and that the transactions were not different in substance and effect from what they appeared to be on their face. The Court's statement of its conclusions in finding for the taxpayers in each case are notable in this area.

> "We may distinguish between general motives of tax avoidance, which admittedly of themselves cannot destroy an otherwise legitimate deduction, and the affirmative motive—of 'investment'—which the government claims is needed to come within this statute. Nevertheless, unless Congress makes it abundantly clear, we do not think tax consequences should be dependent upon the discovery of a purpose, or a state of mind, whether it be elaborate or simple. The limitation which the government asks us to read into the statute, even if appealing in the particular instance, might readily, as we said in another connection in *Eaton v. White*, 1934, (1934 CCH ¶9254) 70 F. 2d 449, at 452, 'create difficulties and uncertainties more objection-

able in their results than any seeming inequities which would be eliminated or prevented.' Granting the government's proposition that these taxpayers have found a hole in the dike, we believe it one that calls for the application of the Congressional thumb, not the court's."

Although the Court, in its language, went rather far in denying even a pure tax motive as a basis for disregarding an otherwise valid transaction the result reached is consistent with the principles enunciated above, that even if the transaction is motivated solely by tax reasons, the existence of the factors of risk of loss or opportunity for profit may be sufficient to sustain the transaction against challenge.

Another facet of the form against substance problem is proper classification or characterization of transactions. An important example of this is presented by the "thin incorporation" cases. In these cases the corporation actually issues its capital stock for stated consideration in money or property and borrows certain sums from the stockholders, evidencing the loan by appropriate instruments of indebtedness.

In such cases, the Commissioner's attempt to regard the loan as in fact capital and the loan instruments as therefore additional stock and the interest paid on the loan as dividends rather than interest are not an attempt to disregard the transaction as totally lacking in substance, but rather to classify the transaction by a criterion of economic reality. If a corporation projects a business which obviously could not effectively function without a certain minimum capital, the taxpayer's attempt to derive tax advantage from a particular characterization will not be permitted to prevent the placing of a true label upon the transaction. This is particularly true and operates in its most vigorous form in closely held corporations where to allow the taxpayer a complete freedom of classification without restraint would leave the Commissioner in a rather helpless position.

On the other hand, the Commisssioner has no right to demand that the funds needed in a corporate enterprise should all be placed entirely at the risk of a business, and a reasonable amount of loan can therefore be justified as properly representative of the taxpayer's desire to hedge the extent of his financial commitment to the obligations of the corporation. As transactions move farther away from self-dealing, examples may be multiplied of situations where a large debt to equity ratio may be justified.

A seemingly valid transaction in every way may be transformed by prearrangement into one lacking in substance. In effect, the prearrangement causes the transaction to be regarded as if the prearrangement had already taken place at the moment that the transaction is consummated, thus destroying the element of risk of loss or possibility of profit. This is illustrated in the case of *Empire Press, Inc.* v. *Commissioner*, 35 TC No. 17 (1960), where the taxpayer sold shares short to a broker-dealer with an agreement to immediately thereafter cover by a purchase of an equal number of shares at a stated price. The taxpayer's purpose was to obtain a deduction for a dividend payable on the stock sold short. In sustaining the Commissioner's disallowance of this deduction, the Court emphasized the fact that the entire transaction was pursuant to a "prearranged plan."

If the short position in that case had been open at the time of the dividend and remained open and if there had not been the prearrangement to assure the covering of the short position without loss, the taxpayer would have been open to all the risks of the market and the transactions would have become real even though prompted by a tax motive.

The determination of when form will be disregarded in favor of substance will be tested by somewhat different criteria in transactions not ordinarily entered into for the direct and immediate purpose of making a profit. This may be illustrated by the use of multiple trusts and multiple corporations in order to gain tax advantages. Here the economic reality of the transaction and the normality of the forms employed will affect the determination of whether the tax benefits from such multiplicity will be granted. Although this area has been the subject of numerous decisions it will suffice to refer to some recent cases as illustrations of the principle involved.

Thus in *Boyce* v. *United States*, 190 FSupp 950 (WD La, 1961), the taxpayer attempted to obtain exemption from tax by the creation of 90 trusts for a single beneficiary. The District Court drew the obvious inference from this type of situation, stating:

> "Applying the rule of close scrutiny here, as we believe we must, we can reach no other conclusion than that this entire scheme is a mockery of our tax laws. On its very face, the creation of 90 separate trusts for such a relatively small amount of property is preposterous. It blunts the statutory purpose of our laws . . . . Surely the burden of proving literal compliance with the terms of such a bizarre arrangement rested heavily upon plaintiffs here."

A similar disposition in the area of multiple corporations was made in *Shaw Construction Co.*, 35 TC No. 115 (1961) (citing the *Boyce* case) where the Tax Court ignored the use of 88 separate corporations to carry on an undertaking which would normally have been conducted by one or a few corporations. Similarly in *Aldon Homes*, 33 TC 582 (1959) the Court ignored the use of 14 separate corporations to conduct taxpayer's business, quoting from the opinion of Judge Learned Hand in *National Investors Corporation* v. *Hoey*:

> ". . . [T]o be a separate jural person for purposes of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation: in other words, that the term 'corporation' will be interpreted to mean a corporation which does some 'business' in the ordinary meaning; and that escaping taxation is not 'business' in the ordinary meaning." 144 F (2d) 466, 468 (2d Cir. 1944).

On the other hand, one can envisage the ownership of a large number of parcels of income producing real property, each owned by a separate corporation where multiplicity of the corporations could be justified on the basis that it is a common pattern to hold separate parcels of income producing real estate in separate corporations. Here non-tax factors, such as limiting mortgage liability to the particular parcel, and the normality of the forms employed based on the general business custom, negate the argument of absence of economic reality.

Here, the Commissioner is also armed with certain specific statutory weapons, such as Section 269, acquisitions made to evade or avoid income tax, and Section 1551, disallowance of surtax exemption and accumulated earnings credit. Section 269 takes its toll where "the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy." Section 1551 disallows the surtax exemption and accumulated earnings credit unless a transferee corporation establishes by a clear preponderance of the evidence "that the securing of such exemption or credit was not a major purpose of such transfer."

Thus the statute has made motive a determining factor regardless of the reality and substance or valid business purpose of the transaction. None of the judicial decisions which rejected taxpayer's motive as a factor would quarrel with the vital relevance of motive under these statutory provisions.

Whether a given transaction is to be regarded as a purchase of property or a lease of property has been the subject of numerous litigated cases and rulings which have involved, in a variety of forms, the whole substance against form problem. The income tax differences between a lease and a purchase are so significant that the "seller-lessor" and the "purchaser-lessee" have attempted to secure characterization of the transaction most favorable to each. In this area we have a pilot example of attempted clarification of the guideposts which will be used to determine the treatment of a given transaction. These rules are embodied in a series of rulings based on court decisions. See Rev Ruls 55-541, 55-540 and 55-542, (CB 1955-2, 19, 39, 59, respectively); Rev Rul 57-371, (CB 1957-2, 214; Rev Rul 60-122 (CB 1960-1, 56). It is to be hoped that in due course of time other areas of this problem will be similarly charted to reduce the uncertainty which presently prevails.

These rules are based on the premise that payments are deductible as rentals where the taxpayer has not taken title, or is not by the agreement to take title, or has no equity. In this sense, "equity" would signify some economic interest in the property as such. The tests laid down in the rulings of the Commissioner as well as in the decided cases resolve themselves into an effort to arrive at the basic intent of the parties which is to be sought from a series of criteria in the light of all the surrounding facts and circumstances at the time the transaction is entered into. These criteria are as follows:

1. The existence of a purchase option and the effect and relation of the option price to earlier rentals paid.
2. Inference of right to purchase from industry practice or right to retain by reason of non-removability of property.
3. Substantial reduction of rental for renewal periods.
4. The effect of designating any portion of periodic payments as interest.

Although the area of lease versus purchase appears to come under the heading of classification of transactions as discussed above, nevertheless, the principles which have been held to govern this segment of the form against substance area, with reasonably clear guides available for predicting the tax outcome in most cases, may ultimately pave the way for some similar attempt to chart the perils in the general area of form against substance.

UNDERVALUATION OF INVENTORIES*

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President Kennedy in his Tax Message to Congress on April 20, 1961, said the following with respect to inventories:

> ". . . It is increasingly apparent that the manipulation of inventories has become a frequent method of avoiding taxes. Current laws and regulations generally permit the use of inventory methods which are acceptable in recognized accounting practice. Deviations from these methods, which are not always easy to detect during examination of tax returns can often lead to complete nonpayment of taxes until the inventories are liquidated; and for some taxpayers, this represents permanent tax reduction. The understating of the valuation of inventories is the device most frequently used.
>
> "I have directed the Internal Revenue Service to give increasing attention to this area of tax avoidance, through a stepped-up emphasis on both the verification of the amounts reported as inventories and an examination of methods used in arriving at their reported valuation."

Secretary of the Treasury Dillon on May 3, 1961, explained the subject more specifically to the House Ways and Means Committee, making it clear that the government was concerned not only as to valuation methods but also as to the accuracy of physical count. The Commissioner of Internal Revenue on May 5, 1961, issued a Technical Information Release (TIR-317), stating in part:

> "Examining personnel have been instructed to place increased emphasis on examination of tax returns involving inventories and to give particular attention to inventory reserves, valuation methods, omission of inventory items, and allocation of costs . . ."

The situation suggests that industry review its inventory counting and valuation procedures (valuation referring to the inclusion of direct labor and factory overhead as well as direct materials in the case of manufacturers and processors) to make certain they produce accurate results for income tax purposes. At the same time, it is important to bear in mind

* Reprinted from LYBRAND JOURNAL, Volume 42, Number 4.

that a taxpayer as a general rule may not change any of its established valuation methods unless permission to do so is obtained from the Commissioner of Internal Revenue. The Treasury's position is that this rule applies even though the methods employed may be erroneous.[1] Under this concept, erroneous methods consistently applied constitute accounting methods for tax purposes and because of relief provisions in the Code[2] it is often desirable to let the government initiate the change, rather than for the taxpayer voluntarily to request permission to switch to a correct method.

Inventory Ground Rules

Taxpayers required to take into account inventory at the beginning and end of the year in order to determine correctly taxable income,[3] and to reflect properly the existence of an asset in reporting financial position.[4] Inventory determination ordinarily involves two steps, (1) physical count of *all* items owned by the taxpayer, regardless of where located and regardless of condition, and (2) valuation of each of those items. Physical count includes a written listing or tabulation identifying the kind and quantity of all inventory items which together with the computed valuation is required to be preserved as a part of a taxpayer's accounting records.[5] Valuation of inventory requires that all goods be identified either as (1) normal goods or (2) abnormal or subnormal goods, having reference to goods which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes. Normal goods must be valued in accordance with the established method or methods employed by the taxpayer, whereas goods not salable or usable in the normal or ordinary course of business should be valued at bona fide selling prices less direct cost of disposition, but in no event less than scrap value.[6]

Practices Not Permitted

Although sometimes employed, the following practices or methods are *not* permissible for tax purposes:[7]

1. Deducting from or reducing inventory value by a reserve for price changes, obsolescence, depreciation, etc. (There is no statutory provision in the Code which permits inventory reserves of any kind.)

[1] Regs. 1.471-2 (d) and 1.446-1 (e).
[2] I.R.C. 481.
[3] Regs. 1.471-1.
[4] Montgomery's Auditing, 8th Edition, page 192.
[5] Regs. 1.471-2 (e).
[6] Regs. 1.471-2 (c) and (d).
[7] Regs. 1.471-2 (f).

2. Valuing work in process or other parts or segments of inventory at a nominal price or at less than a proper value. (See permissible valuation methods discussed hereinafter.)

3. Omitting from inventory portions of the stock or goods on hand. (Physical count must include *all* inventory.)

4. Using a constant price or nominal value for so-called "base stock" or normal quantity of inventory. (See permissible valuation methods discussed hereinafter.)

5. Including in inventory stock in transit, title to which is not vested in the taxpayer. (Inventory includes only goods actually owned by the taxpayer.)

Where a taxpayer engages in any of these practices or methods for tax purposes, a correction or change would apparently be governed by change of accounting method rules.[8] At the present time it is understood that the Commissioner has taken a stand that a change in an erroneous method on the books requires a corresponding change for tax purposes. Under this circumstance, taxpayers who wish to correct their financial statements, although not make any change taxwise, should proceed with caution. Perhaps it might be possible to correct the financial statements without changing the books.

Permissible Inventory Valuation Methods

With respect to normal inventory there are three basic valuation methods, (1) cost, (2) cost or market, whichever is lower, and (3) market value (the use of which, however, is restricted to certain taxpayers[9]). Uniform rules governing the selection of these methods are not prescribed except that the method or methods selected must conform to the best accounting practices in the trade or business and they must clearly reflect income. Consistency from year to year carries greater weight than the particular method selected.[10] But whatever method is selected, whether permissible or otherwise, it constitutes an accounting method for tax purposes.[11]

Cost

For tax purposes[12] cost means (a) in the case of goods on hand which were also on hand at the beginning of the year, the inventory value of

[8] I.R.C. 446 and 481.
[9] Regs. 1.471-2 (c).
[10] Regs. 1.471-2 (a) and (b).
[11] Regs. 1.471-2 (d).
[12] Regs. 1.471-3.

such goods at the close of the preceding year, and (b) in the case of goods on hand which were purchased or produced during the year, the actual cost thereof paid or incurred during the year. As to manufacturers and producers, cost consists of three elements, (1) raw materials becoming a part of or consumed in connection with the product, or "direct materials," (2) labor applied to the direct materials, or "direct labor," and (3) indirect or "overhead" expenses incident or necessary to production.[13]

Indirect Production Expense (Overhead)

Various methods of absorbing production overhead in inventory are practiced by manufacturers and producers and this represents a complicated subject in itself. One application in particular, referred to as the "direct cost method," deserves mention. Under this method, fixed items of overhead, such as depreciation, real estate taxes, etc., are charged to "period" or current year expense and are not included in the total overhead allocated to and absorbed in inventory. It appears this method may be acceptable for tax purposes if adopted at the time a taxpayer is faced with the valuation of his first inventory, provided the method is used on the taxpayer's books as well as in his tax return.[14] The regulations state ". . . the extent to which indirect costs shall be included . . . depends upon the method used by the taxpayer in treating such items in keeping his books. . . ."[15] Adoption of this method at the beginning is significant since at the present time the Commissioner of Internal Revenue will not permit a change from a "full" absorption method to the direct cost approach.

Standard Costs

Concerning the definition of "cost" the income tax regulations intend the term to mean "actual" cost. Therefore, the use internally of "standard costs" in valuing inventory may lead to serious differences between the taxpayer and the government if the standards are substantially different from actual cost.

Trade Practices of Approximating Cost

In a few industries, trade practice has established methods which result in "approximate" cost valuations. Certain of these methods are acceptable and are deemed by the regulations to be cost methods.[16] They include the "retail method" employed by retail merchants, under which

[13] Montgomery's Auditing, 8th Edition, Page 194.
[14] *Geometric Stamping Co.*, 36 TC 301 (A).
[15] Regs. 1.446-1 (c) (ii).
[16] Regs. 1.471-2 (c).

the inventory is taken at selling price and then reduced to approximate cost by application of gross profit ratios,[17] and the "unit-livestock-price method" used by livestock raisers and farmers, in which case the taxpayer is permitted to approximate the cost of raising or producing his animals.[18] Another acceptable trade practice concerns those industries which by a single process or a uniform series of processes derive two or more kinds, grades, or sizes of products. In that case, it is permissible to allocate total cost to the different products on the basis of their relative selling prices.[19]

LIFO

The last-in, first-out method[20] of inventorying is a cost valuation method. Under this method, a taxpayer is permitted to disregard the identity of goods on hand at the end of the year as to when they were purchased or produced and to treat them first as those goods on hand at the beginning of the year and, secondly, with respect to new goods or increased quantities as those purchased or produced during the year. The purpose of LIFO is to freeze a selected cost level for valuing subsequent inventories, with increases in inventory taking the cost level of the year of increase.

Cost or Market, Whichever Is Lower

Under the lower of cost or market method,[21] the cost of each item of inventory is compared with the market value and the lower of the two values is the proper inventory value. This method is the most commonly used because it is a conservative application which recognizes inventory losses when they occur, regardless of when the inventory is sold.

Under ordinary circumstances, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which the taxpayer usually purchases. In the case of purchased goods, market means the replacement price. In the case of manufactured goods, it means the reproduction cost or the necessary amounts of material, labor and overhead at current rates to bring the item to a comparable state of completion. If the item has reached a salable state, market value may be substituted if it is less than reproduction cost.[22]

[17] Regs. 1.471-8.
[18] Regs. 1.471-6.
[19] Regs. 1.471-7.
[20] I.R.C. 472.
[21] Regs. 1.471-4.
[22] G.C.M. 9401, X-1 CB 102; cf. *Bedford Mills, Inc.*, 2 Fed. Supp. 769, cert. den. 290 U.S. 655.

Market

Market[23] value as a basis for inventory valuation is permitted only in the case of dealers in securities and certain commodities and by livestock raisers and farmers. The cost and the lower of cost or market methods are both available to such taxpayers, although past experience has indicated that they frequently find it more convenient to employ a market valuation. Securities and commodities dealers apply a straight market valuation whereas livestock raisers and farmers reduce the market value by the direct cost of disposition. The market value approach in the case of livestock raisers and farmers is referred to as the "farm-price method."

Accounting Method Rules and Inventory Valuation

Prior to 1954 a great deal of conflict had occurred with respect to accounting methods, with the majority of the cases involving inventory. The taxpayer was pitted against the Internal Revenue Service and the Internal Service against the courts, and the courts themselves did not agree. Consequently, Congress in 1954 stepped in, expanded the statutory provisions with respect to accounting methods[24] and enacted new legislation prescribing the tax consequence attending a change of accounting method.[25] The dispute centered around three points, (1) definition of the term "accounting method," (2) conditions under which a taxpayer may change his method of accounting, and (3) adjustments to income which are necessary when a taxpayer changes from one method to another. Congress attempted to resolve all three points.

Definition of Accounting Method

Under the income tax regulations applicable to taxable years after 1953, the term "method of accounting" is defined as follows:

> ". . . The term 'method of accounting' includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. . . ."[26]

Under this definition, the accounting treatment accorded *every* item of gross income and deduction from year-to-year for tax purposes constitutes an accounting method. The definition is derived from the Congressional minutes relating to 1954 Code Sections 446 and 481, and it is abundantly clear that the method of valuing inventory is within the definition. The Congressional minutes disclose:

[23] Regs. 1.471-5 and 1.471-6.
[24] I.R.C. 446.
[25] I.R.C. 481.
[26] Regs. 1.446-1 (a) (1).

> ". . . A change in the method of accounting includes a change in the general method of accounting. . . . It also includes a change in the treatment of a material item such as a change in the method of valuing inventory. . . ."[27]

Therefore, it follows that all rules governing accounting methods apply with full force to practices and methods of valuing inventory.

Conditions Precedent to Change of Method

The confusion in the accounting method arena under the 1939 Code (years prior to 1954) was caused in no small part by a paucity of statutory provisions and of regulations on the subject. Notwithstanding this situation, the Courts usually came to the conclusion that "consistency" was required of the taxpayer unless the Commissioner gave his consent to a change or unless there was a specific statutory provision which allowed a change without permission:[28]

> ". . . Consistency is the key and is required regardless of the method or system of accounting used. . . ."

Under this approach, once a taxpayer adopted an accounting method with respect to an item of gross income or deduction, regardless of whether the adopted method was correct or incorrect, the taxpayer was required to be consistent thereafter. Some decisions,[29] however, indicated disagreement with this approach.

Congress, in enacting the accounting method Sections 446 and 481 of the 1954 Code, has made consistency "mandatory" and a change of method is not now possible unless (1) a specific statutory provision permits the change without the Commissioner's consent, (2) the Commissioner gives his consent to the change, or (3) the item involved in the change is not "material." The rule in force since 1954 is embodied in the following regulation:[30]

> ". . . A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent in secured. . . ."

[27] Senate Committee Report, 83rd Congress, 2nd Session, Report No. 1622, Page 300 (1954).

[28] *Advertisers Exchange, Inc.*, 240 Fed. 2d, 958.

[29] *Beacon Publishing Co.*, 218 Fed. 2d, 697; *American Can Co.*, 37T.C. No. 26.

[30] Regs. 1.446-1 (e) (2) (i).

This regulation is also derived from the Congressional minutes relating to the enactment of Sections 446 and 481 of the 1954 Code. Those minutes state:[31]

> ". . . A taxpayer who changes his general method of accounting or who treats material items inconsistently must obtain the consent of the Secretary or his delegate unless an express provision of this chapter permits such change at the election of the taxpayer without consent. . . ."

It seems to this author that the only doubt remaining in the above rules concerns the term "material." That term is not defined for tax purposes and it is not likely that the definition for financial accounting purposes will be acceptable. Even in the latter case, "materiality" is not perfectly defined. Under the circumstances, it seems advisable to approach basically all changes in accounting methods for tax purposes as being material in nature, with the result that if a change is not available by reason of a specific statutory provision it becomes necessary to request the permission of the Commissioner to make the change. A new standard form (Form 3115) has been provided for this purpose. This form must be filed during the first 90 days of the taxable year in which the change is to be effective.

As to valuation of inventory, it seems apparent that all consistently applied practices employed by a taxpayer in determining the value of items of inventory constitute accounting methods, and, indeed, even though erroneous they may not be changed for tax purposes except under the conditions prescribed above. The *only* change in method of inventory valuation which may be made at any time without the Commissioner's consent is the change *to* the LIFO inventory method.[32] In addition, certain changes within the LIFO method are permitted either generally or for certain specified taxable years under the "dollar-value" LIFO regulations promulgated January 20, 1961.

Adjustments Attending a Change of Accounting Method

Perhaps the most "heat" generated by 1939 Code disputes over changes of accounting methods concerned the tax consequences of changing from one method to another, particularly when the former method was an erroneous method. It was here that taxpayers, the Commissioner and the Courts went in all directions. The question was—did the Com-

[31] Senate Committee Report, 83rd Congress, 2nd Session, Report No. 1622, Page 300 (1954).

[32] I.R.C. 472.

missioner have a right to tax in the year of change the income which, under the correct or newly adopted method of accounting, should have been reported in prior years now closed by the statute of limitations? Frequently, the mitigation of limitations provisions came into play for the injured party, especially where inventory was involved.[33] To end these problems, Congress enacted Section 481 in the 1954 Code.

If an accounting method change is made in any taxable year after 1953, Code Section 481 governs and prescribes all of the adjustments necessary "to prevent amounts from being duplicated or omitted." The underlying purpose of the section is to control in particular the necessary adjustments attending the correction of an erroneous method to a correct method. The following was contained in the Congressional minutes at the time of the enactment of Section 481 in 1954:[34]

> ". . . Your committee felt that permitting the entire adjustment would result, in effect, in *adjusting for errors* which occurred during years when there was no statutory authority for making such adjustment. . . . Therefore, your committee's bill provides that the portion of the net transitional *adjustment which corrects errors* made prior to 1954 will not be made. The transitional adjustments in all future changes under your committee's bill will be those resulting from a change in accounting method determined (under the facts) to be necessary to *adjustment for erroneous treatment* of items subsequent to 1953. . . ."

In its original form, Section 481 excluded from the required transitional adjustment all income and deductions attributable to pre-1954 years. The Treasury resisted this exclusion and as a result Congress in 1958 amended the new provisions retroactively so that the pre-1954 exclusion or exemption is applicable only when the accounting method change is initiated by the Commissioner. The following excerpt is from the Congressional minutes at the time of the amendment in 1958:[35]

> ". . . Section 481 of the 1954 Code *for the first time* provided statutory rules with respect to these adjustments. This section requires these adjustments to be made in full to the extent that they are attributable to 1954 or a subsequent year. However, no adjustments are required which are attributable to years before the application of the 1954 Code.

[33] 1939 Code Section 3801 (1954 Code Sections 1311-1315).
[34] Senate Committee Report, 83rd Congress, 2nd Session, Report No. 1622 (1954).
[35] Senate Committee Report, 85th Congress, 2nd Session, Report No. 1983 (1958).

". . . The House report suggests that there is no reason why the pre-1954 Code years adjustments should not be made, when taxpayers, of their own volition, have changed their method of accounting."

Accordingly, the rule under Section 481 is that if a taxpayer today initiates a change of an erroneous accounting method he must *in the year of the change* report the net amount of all income and deductions attributable to prior years under the correct or newly-adopted method of accounting to the extent that such income and deductions were not reported by reason of the use of an erroneous accounting method. It is immaterial that the prior years may be closed under the statute of limitations—omitted income and deductions of *all* prior years are reported in the year *in which the change of accounting method is made.* The Code therefore permits, indeed requires, the "bunching" of income in the year of change. Some relief is given in the form of special tax computations for the year of change and also in the form of an optional 10-year spread-forward of that portion of the current year adjustment which represents pre-1954 income.[36] The optional spread-forward is not available for accounting method changes after 1963. The only *exemption* of prior years' income available is when the Commissioner, rather than the taxpayer, initiates the change of accounting method. In that case, the omitted income and deductions attributable to pre-1954 years are excluded from the current year adjustment.

The mechanics of Section 481 require that for the year of change of accounting method the taxable income must first be computed on the basis of the correct method of accounting. The next step is to determine the adjustments necessary to prevent duplication or omission, and the quickest way to do this is simply to compare the opening tax basis balance sheet under the correct accounting method with the opening tax basis balance sheet under the erroneous method. The net difference in balance sheet accounts having an effect upon taxable income represents the "net adjustment" under Section 481. The net adjustment, if it represents additional income, is added to the income determined under Step 1. If the net adjustment represents a deduction, it is deducted from the income determined under Step 1. The result is taxable income for the year of the accounting method change, unless, of course, the taxpayer elects a spread-forward with respect to the pre-1954 income portion of the net adjustment. The spread-forward is not available if the net adjustment represents a deduction.

[36] I.R.C. 481 (b).

To illustrate the foregoing with respect to correction of an erroneous method of valuing inventory, assume that a calendar year taxpayer has been in business for many years and has consistently employed an erroneous method of valuing inventory. A change to a correct method is made during 1960. The necessary facts to apply Section 481 are as follows:

	Inventory Value	
Inventory Date	*Erroneous Method*	*Correct Method*
December 31, 1953	$100,000	$150,000
December 31, 1959	140,000	200,000
December 31, 1960	180,000	300,000

Assuming the taxpayer initiated the change and obtained the Commissioner's consent as required by the rules, the taxable income for 1960 would be computed first by using an opening inventory of $200,000 and a closing inventory of $300,000. To the income so determined, a "net ajustment" of $60,000 would be added, since the net adjustment represents additional income. Optional spread-forward provisions would be available with respect to $50,000 of the $60,000. The net adjustment of $60,000 is the amount of income omitted in prior years and is simply the excess of the correct inventory value over the erroneous value at the beginning of the year ($200,000 less $140,000). The portion of the net adjustment attributable to pre-1954 years would be the difference between the correct and the erroneous inventory values at December 31, 1953, or $50,000 ($150,000 less $100,000). If the Commissioner, rather than the taxpayer, initiated the change, the pre-1954 income of $50,000 would be exempt and the 1960 net adjustment would be limited to $10,000 ($60,000 less $50,000).

The above illustration demonstrates the *unimportance* of whether prior years' statutes of limitations are open or closed.

Penalty of Inconsistency or Change without Permission

It is clearly stated in the regulations that the term "method of accounting" includes not only the over-all accounting method but also the accounting treatment accorded every item of gross income and deduction. It is equally clear that any substantial inconsistency in the treatment of any item of gross income or deduction constitutes a change of accounting method and that a change of accounting method is not permissible without the Commissioner's consent unless there is a specific statutory provision allowing the change without permission. Therefore, if a taxpayer makes a change in violation of these rules he invites the wrath of the Commissioner. If a change is made without permission, it may or may not be permitted at the time the Internal Revenue Agent examines the tax return. In any event, allowance of such a change is entirely discretionary on the part of the Commissioner and it may well be that years after the change has been made the taxpayer will be required to return to his old method, even though the old method is erroneous.

As pointed out previously, consistency is mandatory.[37] An erroneous method, consistently applied, may as a matter of fact clearly reflect income, in which case the Commissioner has the authority to approve the continued use of the erroneous method:[38]

> ". . . the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the Income Tax Regulations, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. . . ."

Mitigation of Limitations, Sections 1311-1315

The basic purpose of the mitigation of limitations provisions is to permit the opening of the statute of limitations with respect to a closed year to prevent either the taxpayer or the government from profiting taxwise from inconsistency. It is believed in some quarters that the government will attempt to employ the mitigation of limitations provisions to overcome the pre-1954 income exclusion provided by Section 481 when the government, rather than the taxpayer, initiates a change or correction of an inventory valuation method. It might appear that Revenue Ruling 58-327[39] gives credence to this belief. The summary of that ruling states:

> "Inventories constitute items of gross income within the meaning of Sections 1311 to 1315, inclusive, of the Internal Revenue Code of 1954, or Section 3801 of the Internal Revenue Code of 1939, relating to the mitigation of effect of limitations and other provisions with regard to items affecting taxable income."

A careful study of this ruling discloses that it involves taxable years prior to the time Section 481 became effective and, as well, the issue does not relate to adjustments attending a change of consistently applied ac-

[37] *Advertisers Exchange, Inc.*, 240 Fed. 2d, 958; *Ross B. Hammond*, 97 Fed. 2d, 54; *St. Paul Union Depot Co.*, 123 Fed. 2d, 235; *Brown v. Helvering*, 291 U.S. 193; *Schram*, 118 Fed. 2d, 541.

[38] Regs. 1.446-1 (c) (2) (ii).

[39] C.B. 1958-1, 316.

counting method. Accordingly, there is no apparent conflict between this ruling and Section 481. It may be that the situation requiring adjustment was caused by a non-recurring year-end inventory pricing error. It follows that this ruling would complement or supplement rather than conflict with Section 481.

In this author's opinion, Sections 1311 to 1315 have no application to correction of an erroneous accounting method. Section 481 prescribes the necessary adjustments to correct for prior-year error, and it precludes the necessity of opening closed years by *requiring* that the amount of prior-year error be reported *in the year of the accounting method change.* Contrary to 1939 Code provisions, Section 481 permits, indeed requires, the bunching or distortion of income for the year in which the accounting method is changed or corrected.

SIXTH SESSION

FRIDAY, MAY 18, 12:30 P.M.
Ohio Union—East Ballroom

Presiding:

C. C. SLAIN, *President, The Institute of Internal Auditors; Manager, Auditing, International Harvester Company, Chicago, Illinois.*

Presentation of Hermann C. Miller Memorial Scholarship

COLIN PARK, C.P.A., *Partner, Haskins and Sells, Columbus,* making presentation to: BARRY G. KING

Address: "There's No Accounting for Taste"

J. PHILIP MARTIN, *Manager, Community Relations Department, Ford Motor Co., Dearborn, Michigan*

THERE'S NO ACCOUNTING FOR TASTE

J. Philip Martin
Manager, Community Relations Department
Ford Motor Company
Dearborn, Michigan

I was very pleased to note that your curriculum of the last two days was quite comprehensive and that there are very many subjects I will not have to cover. I will not, for instance, have to provide "An Interpretation of the Basic Accounting Postulates" (I am glad of that), nor even explain the "Tax Aspects of Inventory Valuation." One wonders, in fact, after looking over this schedule, what in the world there can be left to talk about.

I was also pleased to note that these subjects have been treated by reasonably well qualified people. I would say, in fact, that every speaker on this program might know even more about accounting than I do. It is even possible that some of you do. If there is anyone here who does not, he is in a very bad shape.

I will admit that I did speak to the American Society of Women Accountants in Cleveland last month and here in Columbus a year ago, but, of course, these engagements were due to my profound knowledge of women, not accounting.

In truth, my knowledge of accounting is so limited that it is not only difficult to draft an appropriate speech, but I have a hard time even coming up with a title that accounting people will allow on their programs.

For the Society of Women Accountants, I offered as my speech title "Accounts Deceivable." That exhausted my repertoire right there.

Now, the listed title of my talk today was born of impulse. It was born on the day Mr. Fertig wrote and asked me for a speech title. On that morning I was seated in my office reading the newspaper (which is one of the necessary daily functions on the exacting schedule of a public relations man). I was reading of how so many more people this year were buying Chevrolets than were buying Fords and my reflections of this phenomena prompted my sending Mr. Fertig the speech title listed in your program.

Although their weird public performance is the reason for my title, it will not be the subject of my talk. (It is sickening enough even to read about it let alone talk about it.) What I am going to talk to you accountants about is public relations. As a registered lobbyist to this convention from the Public Relations Society of America, I say, "*When are you fellows going to stop being so nasty about our expense accounts?* Have not you got the remotest notion about what is keeping our American economy on an even keel?"

Seriously, it is not because you are accountants that I choose to talk of public relations. It is because you are members of, or related directly to, the business community, and business more than ever before must realize the growing importance of public relations.

How important is public relations? A better question is how important in public opinion? Public opinion has always been a strong force in a democratic society. But several developments have combined to make it a far more powerful influence than ever before.

First, people have more opinions about more things because more things directly affect them. Our society is becoming increasingly interdependent. The rugged individualist cannot and does not exist except as a pose.

Our urbanization, incorporation and collectivism have developed to the extent that all of us are interdependent members of one or several common interest groups. Everything affects us. It is not possible to mind our own business without sticking our nose into the other fellow's. It has become necessary for us to be better informed and to take an active interest in everything that is going on around us.

Also, public opinion crystalizes more quickly than it ever did before. We form our opinions or have them formed for us with amazing swiftness. We can hear of something happening tomorrow morning and have our opinions delivered into our living room via the "six o'clock newscast."

Corporations have become more vulnerable to public opinion. The bigger everything is the more it attracts public opinion and the more it is affected by it. Giant oaks can neither hide nor bend with the wind.

Some 70 years ago, Cornelius Vanderbilt said, "The public be damned." (It was undoubtedly a very impulsive remark. I am certain that in the Old Commodore's opinion he said a lot of far more important things. But this is the one we remember.)

As evidence of the change that has taken place, a few weeks ago a corporation executive appeared on television to explain to the American public why his company had felt it necessary to raise the price of their product. I have no intention of advancing any opinions as to whether or not the proposed increase was justified. The cost figures presented seemed to indicate quite definitely that it was. The only point I wish to make is that the executive considered it both proper and necessary—and this might have been the first time this has ever happened—to appear on television to explain to the public a company decision that could heretofore have been considered its own business.

The fact is: *it* was *proper* and it was *necessary*. It was proper because every member of the public loses a few dollars by an increase in steel price just as directly and as inescapably as by an increase in taxes. Since the citizen has the opportunity to vote on government tax increases, he considers it his right to pass judgment on a privately imposed tax.

Why is it necessary that a corporation concern itself about the citizen's judgment? Simply because a majority opinion of the public can support legislation or governmental action, union action, competitor action, or consumer action injurious to the corporation.

There should be no doubt on the part of any company as to what public opinion can do to it. The question is, what can *it* do to public opinion, and the pursuit of that question is what we call public relations.

Business and industry must do a much better public relations job than ever before. A consideration of public opinion must attend every corporate decision if for no other reason than it will affect the successful prosecution of the decision. This consideration may or may not affect the basic decision but it will certainly affect aspects of it and particularly the timing, the method and the manner of its introduction to the public.

But more is involved than developing a public relations instinct. What is required is the development of a public conscience. Corporations may be private in the eyes of their management but only as long as they serve the public to the public's satisfaction will they be allowed to exist. The corporate manager may consider himself a private businessman but ultimately his existence is as dependent on the public's favor as that of the public office holder. In total, what all members of the business community must develop is an increased sensitivity and responsiveness to the opinions and the needs of all of the people. The realization of this is the first step toward effective public relations.

Public relations, like charity, begins at home. This local effort is usually referred to as community relations. It is an at-home, on-the-spot attempt to prove, by deeds and conduct, the truth of the story that business is trying to tell on a nation-wide basis concerning its own nature and the merits of the free enterprise system.

And, of course, both locally and nationally, action means more than words: A positive and vigorous attempt to make democracy work is a more effective defense against creeping socialism than verbal assaults against the philosophy and its advocates; assistance to a community's efforts to take care of itself is more sensible than complaining of communities' dependence on federal programs; hiring members of minority groups is more constructive than complaining about their presence on welfare roles.

In short, a programmed extension of the benefits of free enterprise to more and more people is more effective than oratorical panegyrics of free enterprise.

And above all else, of course, business must demonstrate a perfect conformance not merely to the law but to all accepted moral codes and business ethics and must develop self-regulatory procedures that will prevent any possibility of business actions occurring that would disillusion those people in the world who believe in free enterprise and would provide additional weapons to those who do not.

The situation also calls for a knowledgeable participation in all social and political issues in an honest attempt to find the answers rather than a stubborn attempt to resist whatever answers are proposed by others.

A few cases in point: My own state suffers from a deficient tax revenue. Unless this revenue is increased, the total economy of the state will continue to suffer. What is required is not a resistance to any or all tax plans proposed, but the active cooperation of the business community with the government in the framing of tax bills that will be adequate and equitable.

Another case: The President's proposed tax revision program attempts to prevent corporations from using foreign countries as tax havens. This attempt may be justified. Unfortunately, the bill would extend beyond tax haven operations to impose an inequitable tax burden on legitimate manufacturing operations. Tax haven abuses can be corrected without doing violence to the basic principles of tax law and without inflicting injurious consequences on legitimate United States owned enterprises operating overseas. The business community's efforts, therefore, should be directed toward assisting the present Administration in the development of a more discriminating program rather than a stubborn opposition to the total program.

Whether it is the nature of legislators or legislation, it seems that most reform bills tend to throw the baby out with the bath water. This is why we need businessmen in politics. Not to form a solid block for or against legislation, candidates, or parties but to give expert assistance to government in arriving at equitable and practical governmental or legislative decisions.

This is why legitimate lobbying is essential to good government. The lobbyist—the good one, that is—works with legislators in the development of legislation and brings the facts and figures to the legislature that are necessary to the development of good legislation.

The businessman can be an effective force in politics only if his attitude is constructive. The desire to give must outweigh the desire to get. And the expectations should be realistic. Politics is a percentage game. No one wins all of the things he wants nor all of any one thing he wants. And just as the businessman's objectives must be reasonable, so also should his objections be reasonable.

John Bright, a prominent English statesman of the 18th century, once criticized a group of contemporaries with the statement, "Had they been in the wilderness, they would have complained of the Ten Commandments."

Similarly, some businessmen seem to live in a constant disposition of outrage concerning political positions of the party they do not support. They should remind themselves that they claim to be in favor of a strong two party system. Personally, I feel the same about political parties as about sex. There should be two—no more, no less—and both parties should be as good as we can make them. For example, I think it would be disastrous to our country if one party developed into a labor party.And the surest way to bring this about would be to develop one into a business party. Business purposes are best served when businessmen are active participants in both our political parties. Putting all one's eggs in one party basket can assure businessmen of nothing more than a series of short feasts and long famines.

Political hate clubs, the smirking exchange of political jokes of questionable taste, portentious announcements of impending doom, a ridiculous exaggeration of the implications or dangers attending political actions of the opposition or the motive behind them, or any and all evidences of business bigotry only discredit themselves.

These statements are not made to deprecate the business community's position on many current and important issues. It is because these issues are tremendously important not only to business but to our country as a whole that business must improve its political and public relations effectiveness.

A year ago while riding from the airport to the hotel, I asked the cab driver how things were in Columbus. He began to give me a sad story about plant layoffs and unemployment and ascribed the difficulty to American firms buying things from overseas. "The Ford Motor Company, for instance," he said, "is buying their engine rods from West Germany. If the government or unions don't stop these fellows from doing this kind of thing pretty quick we're all going to be out of work."

The cab driver seemed to have some very strong convictions on the subject and I did not feel the distance from the airport to the hotel was sufficient to allow me to convert him so I kept my mouth shut.

You will notice that the cabbie figured that either the government or the unions or both should control Ford Motor Company's business decisions. And although his reference to Ford Motor Company was not quite accurate, his major failure was his inability to see the ultimate rather than the whole picture; to see, for example, that if the purchase of better or less expensive foreign-made materials or parts adds up to a better made or less expensive American product, America will be in a better position to win our international economic war. He probably failed to realize that we were *in* an economic world war. We are. And this is not a cold war but a hot war.

If we lose this war we lose everything that America is. We lose our national freedom because a country that is not economically strong cannot be militarily strong or politically independent. If we lose this war, our present system of government would collapse because a democracy is based on the successful operation of a private enterprise system and when we cannot look to our free enterprise system to provide the necessities of life, then we will have no alternative but to look to the government.

We cannot win this war by refusing to buy Japanese matches, or German autos, or by practicing any other form of economic isolationism. We can meet foreign competition only by competing.

Actually, as we here recognize, there is as much opportunity as danger in the tremendous economic resurgence of the Western European free world countries. The same participation in the economic cycle that made an enterprising business prosperous in an expanding America can make an enterprising America prosperous in an expanding free world.

The public relations job that business must do is to make it plain to the people that to convert the danger into opportunity we must develop the economic discipline in terms of cost, price and quality that is necessary to compete successfully. Our job, then, is to do everything possible to produce our goods faster, cheaper, and better.

One of the ways we can do this, of course, is by increased automation. And here is another so-called business issue that is more than that. Almost everyone professes to believe that automation is good because it is progress and they are afraid to be against progress. But many advocate that if automation allows people to produce a greater volume of goods per week, they should work a correspondingly shorter week; that if automation allows goods to be produced at a lower labor cost, that wages should be correspondingly increased.

In short, they do not wish to destroy the machines like the saboteurs of old, but just deny its purposes. Progress from wooden shoes to wooden heads is not progress.

Business faces an admittedly difficult and necessary job of communicating the idea that, although it is proper for us to expect some immediate benefits from our advancements, we cannot be too demanding in our immediate desires or we will fail to realize our ultimate goal—that if our appetite for golden eggs is not restrained our goose is cooked.

Business also has a task of presenting automation in positive terms, to associate the term with employment, not unemployment. It seems hard to understand why there is still a negative attitude toward technological improvement when there is at least a hundred year history that it is something good. I doubt that there are many things that have been proved so many times as the proposition that technological improvements inevitably, and in most cases immediately, bring the people more goods, more money, more jobs. For a hundred years it has done this and for the same hundred years there have been people saying it did not all the time that it did.

There is no denying that progress means change. Technological progress means changes in many things including industry, jobs, and the skills necessary to the jobs. In constant progress there is constant adjustment. In the main, technological improvements always did and do now create more jobs than they eliminate and if we think positively instead of negatively, we would realize that our employment figures prove it and prove that we need more automation, not less.

Business has the same task in influencing the people's ideas of bigness. People liked business bigness during the last war because that was what was needed to win the war. But what about our present economic world war? Now more than ever before we need the great repositories of research facilities, production facilities and investment ability that bigness provides.

Here again, of course, the conduct of business is more persuasive than messages. Whenever business becomes self-serving rather than public serving, whenever its actions either are or seem to be unresponsive to the public will, it cancels out a million business speeches expounding the virtues of free enterprise.

And what of the profits of business? Somehow, in spite of all business-sponsored economic education programs, the profits are still regarded as surplus or excess funds rather than working capital. Profit is not understood as a tool necessary to the refurbishing and improvement of the company's facilities. Profits must be larger not smaller if we are to win our economic world war.

These are a few of the issues that affect everyone but because they are considered to be business issues, business has the primary responsibility for informing the public of their significance.

But if business's side of the story is to have any credence, businessmen themselves must demonstrate they are in tune with the times. Too many of the business community are lecturing today's audience from yesterday's platforms. If they are to be understood, they must abandon the city club cliché for up-to-date rationality.

At the same time that corporations are being accused of bigness, corporate executives are bewailing the bigness of government. Let us face it. Both business and government have become big by an evolutionary process natural to our political and economic system, and necessary to the scope and complexity of the social and economic world in which we now live. The growth of both must be constantly observed and controls must be applied when it is in the manifest public interest to do so. But it is not in the public interest to cripple either.

Just as government must use its increased powers with the greatest restraint, so must business recognize that with bigness comes responsibility and increased accountability.

Whether the corporation likes it or not, there is no longer any such thing as a "strictly business decision." Whether or not the good old days were really good, they *are* really gone.

Laissez faire capitalism lies stone cold dead in the market place. It started to die soon after its birth and has now been dead a very, very long time. Most businessmen know this. As soon as all do, business can begin to speak to the public in a clearer voice and will be better understood—and it is important that it is.

It is important because more is involved than the well-being of business. The public's opinion on foreign competition, automation, profits, bigness and similar matters affects our country's destiny as surely as their opinions concerning communism, fall out shelters and disarmament.

So, let no one in business, be he a corporate board chairman or accountant, be boastful of his political incompetence or comfortable in a confessed ignorance of public relations. The free enterprise system which sustains us all so well was built in the first place through the businessman's thorough understanding of business. But the time has come when it can be maintained only through the businessman's thorough understanding of public relations and politics. When this has been accomplished, and it had better be accomplished quickly, not only the safety and future development of American business will be assured but also the safety and development of our country and free world.

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